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**POST-TERMINATION
OWNERSHIP ISSUES FOR
DESIGN PROFESSIONALS
AND SURETIES**

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I. INTRODUCTION

The purpose of this paper is to outline the ownership issues which might arise after a termination for default, from the perspectives of the design professional and the surety for the prime contractor. It goes without saying (but must nevertheless be said) that this paper is not an exhaustive survey either of the potential issues or of the applicable law. Rather, the purpose of this paper is to outline the most common ownership issues which will confront a design professional or a surety post-termination, to briefly analyze the law applicable to these issues, and to suggest practical approaches for confronting and resolving these issues.¹

II. ISSUES FOR THE DESIGN PROFESSIONAL

The termination of a design professional does not implicate the vast majority of the issues which are presented when the prime contractor is terminated (e.g., ownership of equipment, unincorporated materials, subcontracts, etc.). Instead, the single most important consideration stemming from the termination of the design professional is the copyright ownership of the designer's plans and specifications, and the related question of whether the owner has the right to complete the project in the designer's absence using the designer's plans.

A. Copyright Ownership: I Bought it, so I Can Build it, Right?²

Ownership of architectural plans³ is now a common question in contract negotiations between design professionals and owners. However, in the absence of a contractual clause resolving the issue of ownership, common law provides a definitive answer.

1. The default rule: plans are owned by the designer.

For all works which are subject to copyright protection, the default rule is that the author of the work owns the copyright.⁴ This principle is also reflected in standard industry contracts.⁵ While courts in the past have struggled with the question of whether the designer was the author, this question has now been resolved in the designer's favor.

a. The "work made for hire" doctrine

In the past, project owners who wanted ownership of the copyright for architectural plans claimed that right under the "work made for hire" doctrine. A "work made for hire" is one which is "prepared by an employee within the scope of his or her employment; or ...specially ordered or commissioned for use as a contribution to a collective work...[or] a supplementary work... [or] a compilation...if the parties expressly agree in a written instrument signed by them that the work shall be considered a work made for hire."⁶ Pursuant to this doctrine, the employer is the author of any works made for hire and therefore owns all copyrights in that work.

Owners have previously argued that the nature of hiring a designer makes the works produced by that designer in the course of his or her work for the owner a "work made for hire." Courts in recent years have rejected that contention for several reasons. First, the doctrine applies only to nine specifically enumerated categories of work.⁷ Of those categories, the only ones which could be said to apply to architectural plans are collective works, supplementary works, and compilations. In truth, none of these categories are appropriate for architectural works, and courts have recognized this fact.⁸ Second, designers are not the owner's employees, they are independent contractors.⁹

Because the doctrine applies only to employees, it is inapplicable to the owner/designer relationship.

b. Co-authorship

Owners have also attempted to claim copyrights in architectural plans based on a co-authorship theory. Owners have argued that because their input was vital to the finished plans (program requirements, aesthetic comments, redline changes, etc.), they are co-authors of the plans with the designer. In recent years, courts have also rejected this notion.¹⁰

2. Conveying Copyright Interests

As discussed above, in the absence of an agreement to the contrary, the designer is the author of the plans and the owner of the copyright in the plans. When the designer is terminated for default, the best course of action is for the owner to attempt to negotiate a transfer of these copyrights from the designer to the owner. The transfer of a copyright or an interest therein, must be done in writing.¹¹ There are several approaches an owner may take, depending on the owner's perceived need, ranging from a request for a complete transfer of all copyrights to a simple license. These alternatives are discussed below in descending order of preference from the standpoint of the designer.

a. Ownership by the designer with a non-exclusive license for the owner.

If the owner is simply interested in completing the project without any fears of copyright infringement allegations, this can be accomplished by granting the owner a license to use the copyrighted plans. Under this scenario, the designer retains ownership of the work, but passes a license to the owner which allows the owner unfettered use of the work itself. A typical contract provision in such an instance would be:

The Work is an instrument of the Designer's service. The Designer is the author of the Work and retains all common law, statutory, and other reserved rights in the Work, including the copyright. The Designer hereby grants to the Owner a nonexclusive license to reproduce, modify, and make derivative products from the Work. In return, the Owner agrees, to the fullest extent permitted by law, to indemnify, defend and hold Designer harmless from any claim, liability or cost (including reasonable attorneys fees and defense costs) arising or allegedly arising out of the use of the Work by the Owner if such use has not been explicitly approved in writing by the Designer.

This provision is the most favorable provision from the standpoint of a designer, and accomplishes several important goals. First and foremost, the designer still retains all rights to the work, and is recognized as the author of the work. Second, the owner's needs are met by the granting of a license which will allow it to modify the work and use the work in the future for other projects. Third, the license granted to the owner is nonexclusive, which permits the designer to grant others a license to the work if the need arises. Fourth, in the event the owner uses the work without consulting the designer, the owner is obligated to indemnify and defend the designer from any damages resulting from this use. It is not hard to foresee instances in which the owner might improperly modify the work, exposing the design professional to a claim of some type. The designer needs to be protected in these circumstances. However, it is important to note that many states have anti-indemnity statutes which apply to contracts for design work and which could affect the designer's ability to obtain full protection from the owner. Designers should ensure that the indemnity provision complies with any applicable anti-indemnification statute.

b. A reverse license.

As noted above, the grant of a nonexclusive license should satisfy the needs of most owners. However, if the owner insists that it own the copyright for the work, the

designer needs to address several key concerns. First, the designer should not grant the owner the rights to details which appear in the work but also appear in other materials prepared by the designer (e.g., a standard wall section). Second, the designer should retain the right to create designs which are derivative of the work. This avoids conflict between the owner and the designer if a future project designed by the designer ends up “looking too much like” the project. Third, as with the previous provision, the designer needs to be protected from any claims resulting from the owner’s future use of the work if the designer is not consulted. Fourth, the designer needs to ensure that it will be paid for its work. Fifth, the designer should explicitly disclaim any warranties of fitness for a particular purpose and merchantability in order to forestall any claim, at a later date, that the designer made any implied warranties regarding the design. These needs can be addressed with contractual language like this:

The Work is an instrument of the Designer’s service. The Designer is the author of the Work, and the Designer hereby assigns to the Owner, without reservation, all of Designer’s common law, statutory, and other rights in the Work, including the copyright, upon full payment of all monies due to the Designer under this Contract, including payment for all additional services. In the event a dispute regarding payment arises, this assignment is not effective until after the dispute has been resolved. To the extent that the Work incorporates information and/or designs previously developed by the Designer, the Designer retains all of its rights in such information and/or designs. The Owner, in turn, grants the Designer a nonexclusive license to use the Work in any way, including the creation of derivative products. The Owner agrees, to the fullest extent permitted by law, to indemnify, defend and hold Designer harmless from any claim, liability or cost (including reasonable attorneys fees and defense costs) arising or allegedly arising out of any use of the Work by the Owner if such use has not been explicitly approved in writing by the Designer. Under no circumstances shall this transfer be deemed a sale by the Designer, and the Designer makes no warranties, either express or implied, of merchantability or fitness for any particular purpose.

c. Ownership of the work by the owner.

The owner's needs on a given project can occasionally be satisfied only by the transfer of full ownership of the designs without any right on the designer's part to create derivative works. This is typically seen where the project design is new or unique and the owner is attempting to ensure that it stays that way. If the owner is unwilling to accept either of the two licensing provisions suggested above, something akin to the following ownership provision should be insisted upon by the designer.

The Work is an instrument of the Designer's service. The Designer is the author of the Work, and the Designer hereby assigns to the Owner, without reservation, all common law, statutory, and other reserved rights in the Work, including the copyright, upon full payment of all monies due to the Designer under this Contract, including payment for all additional services. In the event a dispute regarding payment arises, this assignment is not effective until after the dispute has been resolved. To the extent that the Work incorporates information and/or designs previously developed by the Designer, the Designer retains all of its rights in such information and/or designs. The Owner agrees, to the fullest extent permitted by law, to indemnify, defend and hold Designer harmless from any claim, liability or cost (including reasonable attorneys fees and defense costs) arising or allegedly arising out of any use of the Work by the Owner if such use has not been explicitly approved in writing by the Designer. Under no circumstances shall this transfer be deemed a sale by the Designer, and the Designer makes no warranties, either express or implied, of merchantability or fitness for any particular purpose.

This provision is identical to the one suggested immediately above, except that the licensing language has been removed. This clause still accomplishes several important goals from the designer's prospective. First, the designer is protected from any liability arising from the use of the work if the designer is not consulted. Second, the owner does not obtain any ownership interest in the designer's standard details incorporated in the work. Third, the transfer is not complete until the designer is paid in full. Fourth, the designer is protected against unwittingly giving any warranties for the

design. Because liability arising from warranties is commonly not covered by the insurance carried by designers, this is a significant concern.

3. Conveying copyright interests at a later date.

Ideally, all issues involving ownership of the design should be resolved ahead of time, and that resolution should be embodied in the contract between the designer and the owner. Barring that, these issues should be resolved as soon after the termination as is practical. However, sometimes ownership of the design will need to be changed after the parties have gone their separate ways. Most commonly, owners who find that a design sells particularly well may be interested in owning the design in order to prevent others (including the designer) from reusing the design, in whole or in part. Additionally, one party may want to change the formerly agreed-upon ownership sometime after the work is complete (typically, the owner decides it wants either a license or exclusive ownership of the work). All of these things can be accomplished, but several restrictions must be acknowledged.

a. Licenses

A license is merely a grant of permission by the owner of the rights in the work to another entity. The license can grant the licensee any of a number of rights: the right to use the work but not modify it, the right to modify the work but not use the original work, or the right to do whatever the licensee wants with the work. The license can be a simple, one-page document, signed by both parties, with language like that suggested above. The license may also explicitly reference the portion of the original contract which makes the designer the owner of the work.

b. Transfer of ownership

It is not uncommon for owners to develop a unique type of buyer's remorse regarding the work; that is, if the work is particularly good, the owner wishes it had secured exclusive ownership of the work in the first place. In these instances, the owner will frequently ask the designer to transfer ownership of the work to the owner. The question of whether, in a given situation, a designer ought to agree to do so cannot be answered generically--each situation must be weighed on its own merits. Some designers commonly transfer ownership upon request (although seldom for free); others never do so. However, it can safely be said that there are situations in which the designer will conclude that it is in his or her best interests to strike a deal with the owner and transfer ownership of the work. Once again, such a transfer can be accomplished in a simple, one-page document, with language like that found above. A transfer must be in writing.¹² As with licenses, it may be advisable for the transfer agreement to explicitly reference that portion of the original contract which made the designer the owner of the work.

c. Transfer of copyrights

If the work has been formally registered with the Copyright Office, transfer of the copyright must accompany transfer of the ownership of the design. However, before the designer agrees to such a transfer, one alternative should be suggested. Owners typically want to hold the copyright in the work in order to prevent anyone else from building similar projects. Owners believe (correctly) that many designers have little interest in pursuing copyright infringement lawsuits against other owners, and for this reason, owners want to hold the copyrights so that they can pursue copyright infringement lawsuits themselves. This particular need on the part of the owner can be fully satisfied

without a blanket transfer of all copyrights in the work from the designer to the owner. The designer can transfer to the owner the right to pursue copyright infringement actions while still retaining all other copyrights in the work. The key provision of such an agreement would approximate this language:

The Work is an instrument of the Designer's service. The Designer is the author of the Work, and the Designer hereby assigns to the Owner the right to bring, in the Owner's name, claims alleging infringement of the copyrights in the Work, including claims which may have accrued prior to the date of this Assignment. The Owner shall bear all of the costs, including all attorneys fees, incurred in pursuing any such claims.

Under such an agreement, the designer loses the ability to bring copyright infringement actions itself, but such a result is preferable to losing all rights in the work.

4. The Useful Article exception.

A significant exception to the copyright law exists, which may be very useful to owners who find themselves trying to negotiate copyright transfers with recalcitrant designers. While, as noted above, a negotiated resolution of the copyright issue is always to be preferred, when such a resolution cannot be achieved, the owner may consider invoking the protection of the useful article exception. In order to understand the useful article exception, a brief primer on the history of copyright law is necessary.

a. A brief history of copyright protection for architectural plans

The right of an author to protect his or her creations is grounded in the Constitution itself, which provides that "Congress shall have Power to...promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries[.]"¹³ Protection for architectural drawings was first extended by the Copyright Act of 1909,

which provided copyright protection to “[d]rawings of plastic works of a scientific or technical nature.”¹⁴ Architectural plans were considered technical drawings under the 1909 Copyright Act. The next major evolution of copyright law came with the Copyright Act of 1976. The 1976 Act continued to afford protection to “technical drawings, diagrams, and models.”¹⁵ The House of Representatives’ Report on the 1976 Act recognized that “[a]n architect’s plans and drawings would, of course, be protected by copyright[.]”¹⁶

b. The “Useful Article” exception

The 1976 Act also gave rise to an exception which to this day poses problems for architectural copyrights. The 1976 Act defined a “useful article” as an article having an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information.¹⁷ Because the intrinsic function of an architectural plan is to convey information (i.e., the manner in which a structure is to be constructed), an architectural plan is not considered a “useful article.” However, architectural plans do *portray* a useful article: the structure itself. The 1976 Act indicates that the Copyright Act “does not afford, to the owner of a copyright in a work that portrays a useful article...any greater or lesser rights with respect to the making, distribution, or display of the useful article so portrayed than those afforded to such works under the law, whether title 17 or the common law or statutes of a State, in effect on December 31, 1977....”¹⁸ Under the law in effect on December 31, 1977, copyrights for works of utility (including architectural plans) protected only against the copying of such works for purposes of explanation, *not* against the copying of such works for purposes of use.¹⁹

Thus, the effect of the “useful article” exception is that an author who owns a copyright in a set of architectural plans can prevent the copying of those plans, but *cannot* prevent someone from building a structure identical to the structure depicted on those plans. Copyright extended only to the *plans themselves*, not to the structure depicted on those plans, even though the design concepts embodied in the plans may never have been known or used before.²⁰

A recent court case in West Virginia²¹ demonstrated the utility of the “useful article” exception for an owner who cannot reach a negotiated resolution with a terminated designer. In that case, the copyright holder (“author”) demonstrated that an architect and builder were in possession of the author’s copyrighted architectural plans and had used those plans to construct a building which, the author contended, infringed on its copyright. The court noted that “[o]ther courts have found that a technical drawings copyright simply does not give the [copyright] owner the exclusive right to build the structure depicted in the plan, and a copyright owner has no claim against another who builds the structure from an infringing plan.”²² The court concluded that a building “cannot be an infringing copy of a technical drawing.”²³

B. Designer Détente: Why Both Parties Benefit from a Polite Divorce

As discussed above, the owner may technically have the right to proceed with the project and build the items depicted on the architectural plans without the permission of the designer. However, both the owner and the designer stand to reap significant benefits from a negotiated dissolution of their relationship. The owner can obtain a written copyright license or assignment, and thereby avoid any questions of copyright infringement. The designer can obtain absolution and indemnity from any problems

which may arise with the design after his or her departure. In short, even if the parties erred the first time around (by failing to negotiate these items in advance and include them in the contract), the termination gives the parties a second chance to get it right. The following is a non-exclusive list of issues relevant to the owner, the designer, or both, which should be considered and, if at all possible, negotiated after the termination.

1. Copyright questions

As discussed above, the parties should resolve all copyright issues, and make it clear who has the right to do what with the architectural plans after termination. It makes sense for the designer to be reasonable during these negotiations---a nonexclusive license will cost the designer nothing and owners should be willing to pay reasonable sums for such a license in order to avoid potential copyright complications. Owners should also be aware that the completion designer may well be (and certainly should be) sensitive to copyright issues, and may demand that the owner indemnify them from infringement suits brought by the terminated designer. The entire issue can be avoided by a negotiated license.

2. Who can we call with a question?

Assuming that the owner retains a completion designer and proceeds with construction, it is almost inevitable that questions will arise about the design. These questions may be raised by the contractor through RFIs, by the completion designer, or by the owner due to changes the owner wants in the design. While many of these questions can be answered by looking at the design documents themselves, in some instances a complete answer requires the input of the original designer, as the only person who understands the assumptions and interrelationships which led to the original design

being what it is. History is replete with instances where replacement designers made mistakes when answering questions or modifying the design because the replacement designer failed to grasp the underlying design assumptions. It is in the owner's best interests (i.e., it is conducive to a successful project) to have the ability to call and ask the original designer discrete questions from time to time. The original designer will likely insist on compensation for its time, but such money is typically money well-spent, considering the problems avoided and time saved by the replacement designer.

3. Who is responsible for changes?

One issue discussed above in connection with copyright licenses, and which bears revisiting, is the question of liability if the designs are changed after the designer leaves the project. The terminated designer would do well to demand that he or she be held completely harmless for any damages resulting from changes made to the designs. The terminating owner would do well to narrowly define the phrase "damages resulting from changes made to the designs," such that the original designer will be liable unless the damage results solely from changes made to the designs. At any rate, the parties would do well to negotiate this liability so (at least) everyone knows what they are responsible for.

III. SURETY'S INTERESTS

A. Introduction and Assumptions

When a surety bond principal defaults on a bonded construction contract, the project owner or obligee will undoubtedly demand performance on the performance bond surety. This discussion will focus on the ownership rights of a surety that takes over completion of the project after the principal's default. This discussion assumes the

following facts: 1) the surety's performance bond is a completion bond, or the surety has elected to takeover the project; 2) the surety has admitted liability; 3) the surety is using a new completion contractor to finish the project (i.e., the surety did not tender its principal as the completion contractor); and 4) the surety has reason to believe the principal may not be able to meet its obligation to indemnify the surety for all costs incurred by the surety in completing the project.

When a surety furnishes a performance bond on a project, it agrees to answer to the obligee for the principal's debt or default up to the penal sum limit of the bond.²⁴ Some obligees draft their own bond forms, but many use the AIA's standard forms. A completion bond is a type of performance bond in which the surety guarantees that the work will be performed.²⁵ Under a completion bond, where the principal has defaulted on its contract, the surety's only option is to take over the project and complete the work.²⁶

Many modern-day projects involve performance bonds that do not specify the surety's specific obligations in the event of the principal's default.²⁷ Under these non-specific performance bonds, the surety has additional options on how to fulfill its bond obligations when the principal defaults.²⁸ One of these options includes the surety taking over the project and completing the work.²⁹ This paper assumes that the surety either furnished a pure completion bond, or furnished a performance bond but elected to takeover the project.

When the surety takes over the project, the surety's main goal should be to finish the project quickly and cost-effectively. This is particularly important since, by agreeing to complete the project itself, the surety often exposes itself to liability for the entire cost

of completion plus other consequential damages for which the principal ordinarily would be solely responsible, even if these costs and damages exceed the penal sum of the performance bond.³⁰ Therefore, the surety should be concerned with keeping the completion costs to a minimum and well within the penal sum limits. One advantage to taking over the project is that the surety has more control than it otherwise might over the costs of completion.³¹ Having access and rights to the principal's materials, equipment, supplies, subcontractors and the contract funds should help the surety keep the completion costs in control.

B. What's Yours is Mine: the Surety's Rights to Materials, Fixtures, and Equipment

Under most indemnity agreements, the principal assigns to the surety all the principal's rights, title, and interest in all project-related supplies, tools, equipment, and materials.³² These provisions are typically enforced in favor of the surety.³³ However, without such language in the indemnity agreement, the surety's interest in the materials and equipment of the bonded project will typically be no more than that of an unsecured creditor.³⁴ This may not be a problem where there are no other entities asserting rights to the materials and equipment. However, there is the real possibility that the defaulting principal is experiencing financial difficulties that would cause its secured lenders to assert claims against the principal's equipment and materials that serve as security for loans to the principal.

Where the indemnity agreement contains provisions regarding the surety's right to the materials, tools, supplies, and equipment, the surety may want to consider filing the indemnity agreement as a financing statement in accordance with the UCC in order to perfect its rights.³⁵ Filing the indemnity agreement enables the surety to establish priority

over potential competing claims of other parties to the supplies, tools, materials, and equipment of the principal.³⁶

Alternatively, the surety may be able to simply negotiate an agreement with a cooperative principal to perfect its claims on the defaulting principal's materials and equipment. The principal would then execute separate UCC financing statements on the material and equipment that the surety wants to claim a security interest in.³⁷

1. The Surety's Right to Unused Materials and Fixtures

Under a typical indemnity agreement where the surety is entitled to all materials and supplies, the materials assigned include all materials on or around the job site, and all materials that have already been purchased or ordered for the project.³⁸ The surety is entitled to these materials, regardless of whether the materials are in transit to the job site, in the process of being manufactured, or are being held in storage prior to delivery to the project.³⁹ The surety is authorized to take immediate possession of the materials and to use them in completing the bonded project.⁴⁰

Since the surety has such a broad right to all the materials that have been purchased or ordered for the project, where the market prices for the materials have increased,⁴¹ the surety can and should use materials that were obtained at a lower cost to finish the project rather than purchasing new materials. Alternatively, if those materials are no longer required for the project, the surety is authorized under most indemnity agreements to sell the materials it acquired via its assignment rights in a public or private sale, with or without notice to the principal.⁴²

However, if the materials have not yet been paid for, but there is an enforceable agreement between the principal and the supplier of the materials, the surety should not

renege on that agreement. The supplier would view this action as a breach of the contract and could bring an action against the surety itself for breach of contract, since by taking over the project the surety is deemed to have “stepped into the shoes” of the principal.⁴³ Alternatively, the supplier could bring an action against the surety’s payment bond. In rare situations, courts have held that suppliers have a right of action against the surety as third-party beneficiaries of the performance bond.⁴⁴ Thus, the surety will likely be obligated to honor the principal’s contracts and obligations to suppliers.

When the surety takes over the completion of the project it is deemed to have “stepped into the shoes” of the principal for all purposes.⁴⁵ This means that the surety assumes full responsibility to complete the work according to the original contract.⁴⁶ Therefore, the surety can be held liable for any breaches of the original construction contract, including defects in the work and damages associated with the delayed completion of the project.

2. The Surety’s Right to Equipment

As discussed above, most indemnity contracts assign to the surety all title, interest, and rights to all job-related equipment for use in completing the project.⁴⁷ Under these circumstances, the surety is entitled to use any equipment required to complete the job rather than purchasing new equipment. Additionally, under most indemnity contracts, the surety is authorized to execute any necessary instruments in the principal’s name in order to provide itself with absolute title to the equipment that was assigned under the indemnity contract.⁴⁸ Thus, even where the principal is uncooperative in turning over the equipment to the surety, the surety can use that equipment to complete the project.

The surety will also want to ensure that there are no secured creditors with superior claims to the equipment. As discussed above, where there is an indemnity agreement, the surety should consider filing the agreement as a financing statement under the UCC in order to establish priority over any competing claims to the equipment.⁴⁹ If there are secured creditors, the surety may want to consider either financing the principal so that it can pay the creditors, or entering into an agreement directly with those creditors, if the costs of doing so would be less than the costs associated with replacing the equipment. These options might be particularly attractive to a surety where the equipment needed is difficult to replace, where there is a short deadline for completing the project, or where the surety will likely have to pay the creditor anyway.⁵⁰

Finally, the surety should also consider the principal's need for the equipment. Where the principal must still perform on other bonded contracts, the surety must weigh the costs of using the equipment to complete the defaulted project with the costs that could be incurred if the principal defaults on other bonded contracts due to lack of equipment. In balancing the costs, the surety should keep in mind that it could be held liable for all additional costs associated with completion of the currently defaulted project, including purchasing new equipment, and all damages due to delays to the completion of the project.

C. Your Friends are My Friends: the Surety's Rights to Subcontractors and Suppliers

Using the existing subcontractors and suppliers to complete the project is usually desirable, since they often already have the equipment, materials, and personnel necessary to timely complete the project.⁵¹ The typical indemnity agreement assigns to the surety all the principal's interests in all project subcontracts.⁵² However, this

language does not ensure that the subcontractor or supplier is required to perform on the original contract at the original price, and subcontractors will often take this opportunity to attempt increase their contract price or obtain some additional incentive.⁵³ In many instances, the original subcontracts may have been terminated when the general contract was terminated.⁵⁴ Thus, the surety must investigate whether it can properly assume the subcontract from the principal either through an assignment from the principal, the terms of the general contract, or the terms of the indemnity agreement.⁵⁵ The surety may also attempt to argue that it is entitled to the subcontractors' or suppliers' performance through subrogation.⁵⁶ The surety would argue that via subrogation, the surety acquires the lawful rights or claims of the principal and the obligee, and therefore the subcontractor or supplier must perform for the surety.⁵⁷

Since there is often much debate surrounding whether the surety can assume the subcontracts and whether the subcontractors and suppliers are required to perform, when possible, the surety should negotiate with the subcontractors and suppliers and reach a new agreement, typically called a ratification agreement.⁵⁸ The surety may have some leverage in negotiations with subcontractors and suppliers via the provisions of the typical indemnity agreement authorizing the surety to compromise and settle any claims of the principals under terms it deems reasonable under the circumstances.⁵⁹ In the ratification agreement, the surety would assert these rights in order to assure the subcontractor that it will pay any outstanding balances under the subcontract.⁶⁰ In exchange, the subcontractor would reaffirm its performance obligation under the subcontract.⁶¹

D. Your Funds are My Funds: the Surety's Right to Contract Funds

When the principal defaults on the contract, the surety is entitled to both the contract funds then due and to all remaining contract funds under the doctrine of subrogation.⁶² The surety is entitled to use these funds to reimburse itself for any costs incurred by the surety in completing the project.⁶³

Traditionally, the surety's rights to the contract funds have been held to take priority over other creditors who might make a claim to the funds, even other secured creditors.⁶⁴ However, these priority rights are not without limits.⁶⁵ In particular, the surety should be concerned with the priority of its rights to the contract funds where the principal has declared bankruptcy.

Bankruptcy is a very real possibility for a financially troubled principal.⁶⁶ Some debate has arisen amongst bankruptcy courts over whether the contract funds are considered the property of the bankruptcy estate.⁶⁷ Where the contract funds are not considered the property of the bankruptcy estate, the surety may immediately demand and receive the contract funds, and use them to pay for losses incurred in the course of completing the project.⁶⁸ However, where the contract funds are considered the property of the bankruptcy estate, the surety cannot immediately demand and receive the contract funds, since doing so would violate the automatic bankruptcy stay.⁶⁹ In addition, as part of the bankruptcy estate, the contract funds could be used in the principal's reorganization, further limiting the surety's rights and access to the funds.⁷⁰ Therefore, if the principal has entered bankruptcy, the surety should investigate whether it may properly immediately demand and receive the contract funds.

E. Your Problems are My Problems: the Surety's Mitigation of Risks

When the surety takes over the completion of a project upon the default of the principal, the surety exposes itself to a number of risks. Chief among these is the fact that by agreeing take over completion of the project, the surety is often liable for all the costs of completion, regardless of the penal sum of the bond.⁷¹ The surety is often coming into a difficult situation, with a principal, subcontractors, suppliers, and obligees who may not be willing to cooperate. However, many of the risks and disadvantages associated with taking over a project can be mitigated by the use of a takeover agreement.⁷²

A takeover agreement is typically between the surety and the obligee, though it can also include additional parties, such as the completing contractor.⁷³ Pursuant to the takeover agreement, the surety promises to complete the project in accordance with the underlying contract in exchange for the obligee's promise to pay the surety all remaining contract balances.⁷⁴ However, the surety and obligee may include additional provisions that would help mitigate the risks discussed above.⁷⁵

One important provision that the surety should consider including in the takeover agreement is a provision capping the surety's liability to the penal sum of the bond.⁷⁶ The obligee may be reluctant to agree to such a provision, particularly if it is unconvinced that the costs of completion will be less than the penal sum of the bond.⁷⁷ However, since completion by the surety is usually the option most desired by the obligee upon default,⁷⁸ the obligee may be willing to agree to this provision, particularly if it is concerned that the surety will not agree to complete the project without the provision.⁷⁹

The takeover agreement should also include other important provisions that could help to reduce the surety's risks involved with completing the project. These include: (1) a description of the work to be performed; (2) a new completion schedule; (3) an agreement that funds disbursed by the surety in completion of the project are to be applied toward the reduction of the penal bond; (4) an agreement that the remaining contract funds are to be paid to the surety; and (5) a reservation of the surety's bond rights and defenses against the obligee.⁸⁰

The surety can also mitigate its risks when taking over the completion of a project by requiring a performance bond for the full amount of completion from the new completion contractor.⁸¹ The new performance bond could either name the surety itself as the sole obligee, or it could name the original obligee and the surety as co-obligees.⁸² In either situation, the effect would be that any liability incurred as a result of the unsuccessful completion of the project by the surety and new completion contractor would be passed to the new completion contractor and its surety.⁸³

F. Summary

When the surety takes over the completion of a project that its principal has defaulted on, the surety faces numerous potential risks and liabilities. However, based on the language of the indemnity agreement, the bond itself, and the underlying construction contract, as well as general principles of subrogation, the surety can exercise rights to the principal's materials, equipment, subcontracts, supplies, and the contract funds in order to complete the project quickly and cost-effectively. In addition, the surety may be able to negotiate new agreements with cooperative obligees, subcontractors, suppliers, and other creditors in order to mitigate the risks and liabilities associated with completing the

project. By thoroughly investigating its rights and options, the surety can effectively control the completion of the project in order to satisfy its obligations under the performance bond in the most efficient and cost-effective manner possible.

VII. CONCLUSION

Termination for default is a drastic measure, and creates a number of issues for all the parties involved in the project. When such a termination has been affected, the goal of all the parties should be to put the project behind them as neatly, quickly, and cost-effectively as possible, and move on to other projects. From the standpoint of the designer, the most important issue is the protection of the designer's intellectual property. This paper has explored that issue and suggested a number of potential resolutions which will both protect the designer and provide the owner with the necessary rights in order to prevent future litigation. From the standpoint of the surety, the most important issue is completing the project quickly and inexpensively. This paper has explored the rights which typically accrue to a surety, and the ways in which the surety can exercise those rights in order to ensure the timely and efficient completion of the project. It is the authors' hope that this paper will assist design professionals and sureties in negotiating the difficult issues surrounding a termination for default and charting a course to calmer waters.

¹ It must also be said that the views and opinions contained herein are those of the authors only, and are not meant to reflect the views and opinions of Watt, Tieder, Hoffar & Fitzgerald, L.L.P.

² Portions of the copyright discussion contained herein have been adapted from "Design Professional Work Product – Ownership and Protection," by Ben Patrick, in Design Professional and Construction Manager Law, ABA Publishing, 2007.

³ This article will use the term "architectural plans" to refer to all types of design documents, including plans and specifications authored by engineers, because copyright law is written using the term "architectural plans" rather than some more appropriate phrase, such as "architectural and engineering plans and specifications."

⁴ 17 U.S.C. § 201(a).

⁵ AIA A201-1997 § 1.6.1: “unless otherwise indicated the Architect and the Architect’s consultants shall be deemed the authors...and will retain all common law, statutory and other reserved rights, in addition to the copyrights.” EJCDC E-500 (2002) § 6.03(A): “All Documents are instruments of service in respect to this Project, and Engineer shall retain an ownership and property interest therein (including the copyright and the right of reuse at the discretion of the Engineer)....”

⁶ 17 U.S.C. § 101.

⁷ *Id.*

⁸ *See, e.g., M.G.B. Homes, Inc. v. Ameron Homes, Inc.*, 903 F.2d 1486 (11th Cir. 1990); *Kirk v. Harter*, 188 F.3d 1005 (8th Cir. 1999); *Zitz v. Pereira*, 119 F.Supp.2d 133 (E.D.N.Y. 1999), *aff’d*, 225 F.3d 646 (2nd Cir. 2000); *Bryce & Palazzola Architects and Associates, Inc. v. A.M.E. Group*, 865 F.Supp. 401 (E.D.Mich. 1994); *Joseph J. Legat Architects v. U.S. Development Corp.*, 625 F.Supp. 293 (N.D.Ill. 1985).

⁹ *Kirk v. Harter*, 188 F.3d 1005 (8th Cir. 1999).

¹⁰ *See, e.g., M.G.B. Homes, supra* note 8, at 1492-93; *Zitz, supra* note 8, 119 F.Supp.2d at 143-45, 225 F.3d at 672; *Bryce & Palazzola, supra* note 8, at 404; *Joseph J. Legat Architects, supra* note 8, at 297-98.

¹¹ 17 U.S.C. § 204. *See also Staggers v. Real Authentic Sound*, 77 F.Supp.2d 57, 68-69 (D.D.C. 1994).

¹² 17 U.S.C. § 204.

¹³ U.S. CONST. art. I, § 8.

¹⁴ 17 U.S.C. § 5(i) (1909 Act).

¹⁵ 17 U.S.C. § 101 (197 Act).

¹⁶ H. Rep., pg. 53-55.

¹⁷ 17 U.S.C. § 101 (1976 Act).

¹⁸ 17 U.S.C. § 113 (1976 Act).

¹⁹ *Baker v. Seldon*, 101 U.S. 99, 105 (1879).

²⁰ *Demetriades v. Kaufmann*, 680 F.Supp. 658, 664 (S.D.N.Y. 1988).

²¹ *National Medical Care, Inc. v. Espiritu*, 284 F.Supp.2d 424 (S.D.W.Va. 2003).

²² *Id.* at 435.

²³ *Id.*

²⁴ *See, e.g., Cal. Civil Code* 2787.

²⁵ *Hunt, supra* note 1, at 20.

²⁶ The Law of Suretyship 82 (Edward G. Gallagher, ed. 2000).

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.* at 86.

³⁰ *Id.* at 87; Stephen J. Trecker, Luther S. Ott, & David W. Case, *The Agreement of Indemnity – The Surety’s Handling of Contract Bond Problems: Administration and Resolution of Performance and Payment Bond Claims*, in The Agreement of Indemnity: Practical Applications by the Surety 63 (1990).

³¹ The Law of Suretyship, *supra* note 3, at 86.

³² Trecker et al., *supra* note 7, at 56.

³³ The Law of Suretyship, *supra* note 3, at 342; *Travelers Indemnity Co. v. West Georgia National Bank*, 387 F. Supp. 1090 (N.D. Ga. 1974).

³⁴ *See e.g. United States Fidelity & Guaranty Co. v. United Penn Bank*, 524 A.2d 958 (Pa. 1987).

³⁵ Trecker et al., *supra* note 7, at 27.

³⁶ *Id.* at 29.

³⁷ *Id.* at 57-58.

³⁸ *Id.* at 56.

³⁹ *Id.*

⁴⁰ *Id.* at 56-57.

⁴¹ Recent significant swings in the price of copper illustrate the importance of carefully considering the effects of commodity price changes when taking over a project.

⁴² *Id.* at 57.

⁴³ The Law of Suretyship, *supra* note 3, at 87.

⁴⁴ *Id.* at 100; Common Sense Construction Law: A Practical Guide for the Construction Professional 368-369 (Thomas J. Kelleher, Jr., ed. 3d ed. 2005).

⁴⁵ The Law of Suretyship, *supra* note 3, at 87.

⁴⁶ *See id.*

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- ⁴⁷ Trecker et al., *supra* note 7, at 56.
- ⁴⁸ *Id.*
- ⁴⁹ *Id.* at 29.
- ⁵⁰ Recall that once the surety has taken over a project, it is often held liable for all completion costs and for damages associated with delays.
- ⁵¹ The Law of Suretyship, *supra* note 3, at 341.
- ⁵² Trecker et al., *supra* note 7, at 58.
- ⁵³ *See id.*; The Law of Suretyship, *supra* note 3, at 341.
- ⁵⁴ Gregory L. Daily & Todd C. Kazlow, *Takeover and Completion*, Bond Default Manual 234 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds. 3d ed. 2005).
- ⁵⁵ *Id.* at 234-35.
- ⁵⁶ The Law of Suretyship, *supra* note 3, at 87.
- ⁵⁷ *Id.* at 87, 419-420.
- ⁵⁸ Trecker et al., *supra* note 7, at 58.
- ⁵⁹ *Id.*
- ⁶⁰ The Law of Suretyship, *supra* note 3, at 84.
- ⁶¹ *Id.*
- ⁶² Common Sense Construction Law, *supra* note 21, at 373; The Law of Suretyship, *supra* note 3, at 420.
- ⁶³ Common Sense Construction Law, *supra* note 21, at 373; The Law of Suretyship, *supra* note 3, at 420.
- ⁶⁴ Common Sense Construction Law, *supra* note 21, at 373; The Law of Suretyship, *supra* note 3, at 328; *see Prarie State Nat'l Bank v. United States*, 164 U.S. 227 (1896).
- ⁶⁵ *See Common Sense Construction Law*, *supra* note 21, at 373-74; *see also The Law of Suretyship*, *supra* note 3, at 434-444.
- ⁶⁶ The Law of Suretyship, *supra* note 3, at 317.
- ⁶⁷ *Id.* at 328-332.
- ⁶⁸ *Id.* at 329.
- ⁶⁹ *Id.*
- ⁷⁰ *Id.*
- ⁷¹ William Schwartzkopf, Practical Guide to Construction Contract Surety Claims 516 (2007).
- ⁷² *Id.* at 513.
- ⁷³ *Id.*
- ⁷⁴ *Id.*
- ⁷⁵ For a more in-depth discussion of takeover agreements, *see Schwartzkopf*, *supra* note 48, at 513-534; *see also Daily et al.*, *supra* note 31.
- ⁷⁶ The Law of Suretyship, *supra* note 3, at 87.
- ⁷⁷ *See id.* at 87.
- ⁷⁸ 4 Philip L. Bruner & Patrick J. O'Connor, Jr., Bruner & O'Connor on Construction Law §12:73 (2002).
- ⁷⁹ *See The Law of Suretyship*, *supra* note 3, at 87-88.
- ⁸⁰ Daily et al., *supra* note 31, at 230-231; Schwartzkopf, *supra* note 48, at 522-23; The Law of Suretyship, *supra* note 3, at 87.
- ⁸¹ The Law of Suretyship, *supra* note 3, at 86.
- ⁸² *Id.*
- ⁸³ *Id.*