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PREJUDICE TO THE COMPENSATED SURETY AS A DEFENSE TO LIABILITY

Mark D. Herbert, Bradford C. Ray, and Kevin A. Croft explore surety obligations and defenses. Their article discusses surety defenses that arise when an owner/obligee modifies the relationship between itself and the surety's principal--either intentionally or negligently. It explains the fundamental duties owed by a surety and how a surety's defenses may be increased should the obligee act in a manner that causes prejudice to the surety, and highlights circumstances that have been deemed to be "prejudice" to the surety. Finally, the authors outline the "cardinal change" and "material modification" defenses and when they arise.

About the authors…

Mark D. Herbert is a graduate of Millsaps College and the University of Mississippi School of Law. Mark is a shareholder at Watkins Ludlam Winter & Stennis in its Jackson and Gulfport, Mississippi offices. Mark concentrates his practice in the fields of construction law and fidelity and surety law and is chairman of its Construction and Surety Practice Group.

Bradford C. Ray is a graduate of the Mississippi College and Mississippi College School of Law. Presently, he is an associate in the law firm of Watkins, Ludlam, Winter & Stennis, P.A. in Jackson, Mississippi. Brad concentrates his practice on construction litigation, fidelity and surety law, and general litigation.

Kevin A. Croft is a graduate of the University of Mississippi, Millsaps College Else School of Management, and Mississippi College School of Law. Presently, he is an associate in the law firm of Watkins, Ludlam, Winter & Stennis, P.A. in Jackson, Mississippi. Kevin concentrates his practice on construction litigation, fidelity and surety law, and general litigation.

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One North Franklin, Chicago, IL 60606 USA
www.iadclaw.org
Phone: 312.368.1494 Fax: 312.368.1854
E-mail: aomaley@iadclaw.org

INTRODUCTION

Absent the advent of the modern compensated surety, many larger, riskier construction projects and most all public construction projects could not go forward. The modern compensated construction surety carefully evaluates its risk in providing performance bonds through its underwriting efforts. What if, however, the owner/obligee, through deliberate or negligent action, fundamentally modifies the relationship between itself and the surety's principal which was so carefully evaluated when the bond was written? This article will address the possible defenses available to the modern surety when such a circumstance occurs.

Fundamentally, the surety's defense to a material modification of the relationship between the obligee and its principal is set forth in the *Restatement of Security*, Section 128(b), comment (f). That section provides:

> The modifications of contract between creditor and principal may be such as are contemplated by the contract in which case no surety would be discharged. They [sic] may be slight variations which by the technical rules which have prevailed in respect to non-compensated sureties would discharge them, although not in fact disadvantageous to the surety. In such a case the compensated surety would not be discharged. They may cause slight and easily measured damage to the compensated surety, so that the penalty of a total discharge of the surety would be disproportionate to the claim attaching to the creditor for the modification. In such a case the surety is discharged only to the extent of the loss. **The compensated surety, however, should not be held to his obligation if the creditor and principal have so modified the contract as to impose a risk of a loss substantially different from the one covered by his obligation. If the change imposes a danger of loss upon the surety which cannot fairly be measured, the surety is discharged entirely.** (emphasis added)

THE EFFECT OF PREJUDICE TO THE SURETY

I. Conduct of the Obligee Relieving the Surety

According to the Restatement (Third) of Suretyship and Guaranty, the duties of the surety and the obligee are "determined by the contract creating the secondary obligation, subject to the defenses resulting from suretyship status[1] (§§37-49)."[2] When the obligee acts in such a way as to cause prejudice to the surety, defenses, in addition to those of the principal, arise in favor of the surety.[3] In considering the surety's defenses, it is of particular importance to determine whether the obligee's actions have merely changed or materially altered the underlying contract between the obligee and principal. It is of much greater importance to determine whether the

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[1] In a construction setting, suretyship status is obtained when pursuant to a secondary obligation (payment bond), an obligee (subcontractor or material supplier) has recourse against the secondary obligor (surety) or the secondary obligor's property. Restatement (Third) *of Suretyship & Guaranty* § 1 (1996).

[2] Restatement (Third) *of Suretyship & Guaranty* § 32(1).

[3] *See* Restatement (Third) *of Suretyship & Guaranty* §§ 37-49.

material change has altered the underlying contract to such an extent that the surety suffers actual harm, disadvantage, or prejudice.

A. Material Change to the Underlying Surety Obligation

Throughout history, the legal system has eroded the effect of prejudice to a surety in light of the advent of compensated sureties. Gratuitous sureties have always been treated as a favorite of the law. [4] Compensated sureties, on the other hand, are not afforded the same protection of gratuitous sureties, such as strict construction of their obligations.[5] A material change in the contract between the principal and obligee, however, may release even the compensated surety from any unperformed portion of the secondary obligation.[6] Section 37(2) of the Restatement of Suretyship and Guaranty relates to acts by the obligees that fundamentally alter the risks imposed on the surety. When these acts occur, the surety is placed in a position fundamentally different from that for which it bargained, and it is unfair to enforce the surety's secondary obligation to an underlying contractual obligation.

1. The Surety Must Establish Prejudice

Given the move toward compensated sureties, a surety will rarely be fully discharged from its obligations because of prejudice; however, in most instances, and to the extent the surety has suffered prejudice, the surety will generally be entitled to a *pro tanto* release. Section 41 of the Restatement of Suretyship codifies the modification of a surety's obligation.[7]

In *Reliance Insurance Company v. Colbert*, the bond obligee sued a defaulting contractor and its surety.[8] On appeal, the surety contended that material alterations were made to the underlying contract without its knowledge.[9] The court determined that if such alterations result in prejudice to the surety and if that prejudice proves impossible of measurement, the surety must receive a total discharge.[10] If, however, the prejudice is subject to measurement, the surety will receive only a partial discharge to the extent of the prejudice.[11] Most important was the court's creation of a presumption of prejudice in requiring the obligee to prove an absence of prejudice.[12]

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[4] Metropolitan Fedl. Sav. and Loan Ass'n v. Adams, 356 N.W.2d 415, 419 (Minn. App. 1984)(holding gratuitous sureties as favorites of the law).

[5] *Id.* (holding compensated sureties are not entitled to corresponding protections as those of a gratuitous surety).

[6] Restatement (Third) *of Suretyship & Guaranty* § 37(2)(b).

[7] Restatement (Third) *of Suretyship & Guaranty* § 41(c)(To the extent the surety is not fully discharged of its obligations, the secondary obligation is modified).

[8] 365 F.2d 530 (D.C. Cir. 1966).

[9] *Id.* at 535.

[10] *Id.*

[11] *Id.*

[12] *Id.*

In *pro tanto* jurisdictions, if there is no demonstrable monetary prejudice, there is no discharge. For example, the Seventh Circuit has held that a surety was not entitled to receive a discharge due to an overpayment in progress payments because the obligee subsequently reduced the overpayment through an adjustment of contract retainage.[13] In *Board of Supervisors of Fairfax County v. Southern Cross Coal Corp.*, the court held that a discharge of the surety was contingent upon a showing of prejudice or harm by the surety.[14] Therein, the surety, after taking over a road construction project, discovered that the contractor had paved over deficient sub grade. The obligee, after researching its options approved the least costly approach. The surety claimed that this change was a material alteration that relieved the surety of its obligations.[15] Disagreeing with the surety, the court held that the surety failed to meet its burden of proof on the material alteration issue due to its failure to rebut the county's evidence in approving the least costly approach.[16]

2. The Cardinal Change Rule

The purpose of a performance bond in the construction context is to ensure that a project owner may seek recovery from the surety to complete the project should the contractor default. A surety's liability upon its principal's default is not automatic. If the project owner alters the scope of the principal's work in a way that the surety does not contemplate, the surety may assert what is known as the "cardinal change" defense.

A cardinal change is one that is not within the contemplation of the parties upon execution of the underlying contract. Section 41 of the Restatement of Surety preserves the cardinal change rule by providing that if a modification is so substantial that it creates a substituted contract or imposes fundamentally different risks on the surety than those in the underlying contract, the surety is discharged.[17] The logic supporting the surety's discharge is that the cardinal change significantly changes the surety's risk.

The most common cardinal change situation occurs when work not within the scope pf the original construction contract is added by change order.[18] *In Union Indemnity*, the general contractor sued a subcontractor's payment and performance bond surety.[19] The court held that where the subcontractor and general contractor made material changes to the underlying subcontract, constituting a material departure from the original undertaking, the non-consenting surety was released from its obligations under the bond.[20]

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[13] *Ruckman & Hansen, Inc. v. Contracting & Material Co.*, 328 F.2d 744 (7th Cir. 1964).

[14] 380 S.E.2d 636, 638-39 (Va. 1989).

[15] *Id.* at 638.

[16] *Id.* at 639.

[17] *Id.* at § 41(b)(i).

[18] *In re Liquidation of Union Indem. Ins. Co. of N.Y.*, 220 A.D.2d 339 (N.Y. App. Div. 1995)

[19] *Id.*

[20] *Id.*

A cardinal change should not be considered as including any alteration of the underlying contract the change must be so drastic from the terms of the original contract that a new contract is formed. Not all modifications amount to cardinal changes.[21]

3. Changes in the Parties to the Underlying Contract

A change of the principal obligor to the contract may give rise to a material modification defense. While a mere change in the principal's corporate or business structure will normally not give rise to a discharge defense, a substantial alteration can absolve the surety of responsibility if done without the surety's knowledge or consent.

In *Employer's Ins. Co. of Wausau v. Constr. Mgmt. Eng.*[22], a subcontractor's performance bond surety brought a declaratory judgment action seeking declaration that its bond obligations were discharged based upon a material alteration of the terms of the bond. Therein, the general contractor was awarded a contract with the navy for $6.4 million. After being awarded the contract, the general contractor subcontracted $2.3 million of the contract to a subcontractor. The day after the $2.3 million subcontract was entered into, a second subcontract agreement between the general contractor and subcontractor was entered into for the general contractor's entire scope of work. The surety, however, was unaware of the second contract until the subcontractor defaulted and the surety was called upon to complete the project.[23] After granting summary judgment in favor of the surety, the Court of Appeals held that the surety was discharged on its bond obligations based on the change in risk pursuant to the superseding contract.[24]

B. Prepayments and Overpayments by the Obligee

The standard overpayment situation normally occurs when the bond obligee declares a default, and the bond principal has been paid a large percent of the contract proceeds while having completed a much smaller percent of the work. The obvious problem is that the remaining contract funds are insufficient to cover the surety's project completion costs.

Although the Restatement provides some authority that a surety may bring a claim[25] against an obligee when the obligee has impaired the surety's rights, the surety typically uses an

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[21] *See Guy T. Williams Realty, Inc. v. Shamrock Construction Co.*, 564 So. 2d 689 (La. Ct. App. 1990), *writ denied, Guy T. Williams Realty, Inc. v. Shamrock Construction Co.*, 569 So. 2d 982 (La. 1990)(change in contract plans did not absolve surety)

[22] 377 S.E.2d 119 (S.C. Ct. App. 1989).

[23] *Emp. Ins. of Wausau*, 377 S.E.2d at 121.

[24] *Id.*

[25] Restatement (Third) *of Suretyship & Guaranty* § 37(4)(depending upon the timing and nature of the obligee's actions, if the surety has performed a portion of its obligations, the surety may have a claim against the obligee to the extent the obligee has impaired or prejudiced the surety and such impairment or prejudice would have discharged the surety with respect to that performance); *see also Nat'l Sur. Corp. v. U.S.*, 118 F.3d 1542 (Fed. Cir. 1997)(Action by performance bond surety on defaulted government construction project seeking 10 percent of amount paid to contractor before default that should have been held as retainage); *The American*

obligee's overpayment as a shield. In cases involving a surety's affirmative claim against an obligee, courts tend to absolve the obligee if its failure is found to be merely negligent; however, the closer an obligee becomes to having actual knowledge of the prepayment or overpayment, courts are more likely to allow a surety to pursue a claim.[26]

In defending claims brought against them by obligees, sureties commonly assert the overpayment defense to reduce their damages. Some courts presume that an overpayment or prepayment is enough to justify a discharge of the surety without any proof concerning prejudice.[27] The prevailing view, however, requires the surety to establish prejudice before it will be discharged.[28] In *Metropolitan Cas. Ins. Co. of N. Y. v. Koelling*[29] the Mississippi Supreme Court addressed a surety's request for *pro tanto* release. The evidence therein showed that the obligee advanced the sum of $21,240 to the principal, however, the value of the work done amounted to only $7,755.[30] The court held that the surety was entitled to a *pro tanto* discharge of its obligations in the amount of the overpayment.[31]

C. Extensions of Time, Insufficient and/or Untimely Terminations

Extensions of time allowed for the performance of a construction contract are usually beneficial to the principal and, under most circumstances, do not cause significant prejudice to the surety. In fact, this defense is often waived by provisions contained in either the bond or the underlying construction contract that allow reasonable extensions of time without notice to the surety. However, § 40 of the Restatement (Third) of Suretyship and Guaranty provides that to the extent the extension of time causes a loss to the surety, the surety will be discharged.[32] Section 40(b) of the Restatement is consistent with cases that permit a surety to be discharged for

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Ins. co. v. U.S., 2004 WL 2181560 (Ct. Fed. Cl. 2004)(Action by Miller Act surety against the United States for the contracting agency's improper release of progress payments to the contractor).

[26] *Transamerica Ins. Co. v. City of Kennewick*, 785 F.2d 660 (9th Cir. 1986)(court allowed surety to recover only those payments made in the absence of good faith); *Argonaut Ins. Co. v. town of Cloverdale*, 699 F.2d 417 (7th Cir. 1983)(surety could not recover for premature payment due to obligee's good faith reliance on architect's certificate).

[27] *Southwood Builders, Inc. v. Peerless Ins. Co.*, 366 S.E.2d 104, 108 (Va. 1988)(A separate showing of prejudice to the surety is unnecessary because a material deviation, in itself, establishes sufficient prejudice).

[28] *Town of Melville v. Safeco Ins. Co. of America*, 651 So. 2d 404, 408 (La. App.,1995)(Impairment of surety's subrogation rights makes available to the surety the pro tanto release of the surety's obligation based on the extent his right of subrogation has been prejudiced).

[29] 57 So. 2d 562, 564 (Miss. 1952).

[30] *Id.*

[31] *Id.*

[32] Restatement (Third) of Suretyship and Guaranty Section 40(b)(1996).

an extension to the principal only to the extent that the time extension causes a loss to the surety.[33] Under such circumstances, a showing of prejudice is the key to the surety's receiving a discharge, as it is with most cases involving an alteration of the underlying construction contract.

In cases where the obligee has given extension after extension to the principal without notice to the surety and then, upon default of the principal, seeks recovery of delay damages, the surety may be discharged to the extent the extension(s) causes a loss to the surety. Some courts have noted that "the obligee may not delay before notifying the surety and then insist that the measure of the surety's liability includes escalated costs arising in the interim between default and demand."[34]

In *L&A Contracting Company v. Southern Concrete Services, Inc.*[35], the U.S. Court of Appeals addressed the issue of what constitutes a sufficient notice of default noting that "it is vital that the declaration be made in terms sufficiently clear, direct, and unequivocal to inform the surety that the principal has defaulted on its obligations …." The court held that, where the obligee only sent letters to the surety that mentioned the principal's delay in performance, such notice was insufficient since formal notice was required under the terms of the bond.[36]

In *Town of Clarkstown v. North River Insurance Company*[37], the court held that the obligee had a duty to notify the surety of the principal's default, even though a notice provision was not incorporated into the surety bond—the law implied an obligation that the obligee notify the surety of the default. However, since the surety failed to establish prejudice resulting from untimely notice, the obligee was entitled to a full recovery under the bond.[38]

Significantly, and as noted by the L&A Court, "[b]efore a declaration of default, sureties face possible tort liability for meddling in the affairs of their principals."[39]

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[33] See *Blackhawk Heating & Plumbing Co., Inc. v. Seaboard Surety Co.*, 534 F. Supp. 309 (N.D. Ill. 1982).

[34] *Id.* (citing *Continental Bank & Trust Co. v. Am. Bonding Co.*, 605 F. 2d 1049, 1057 n. 17 (8th Cir. 1979)).

[35] 17 F. 3d 106 (5th Cir. 1994)

[36] *Id.* at 86; see also *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997).

[37] 803 F. Supp. 827 (S.D. NY 1992)

[38] *Id.; see also Conesco Industries, LTD v. Confoti and Eisele, Inc.*, 627 F. 2d 312 (U.S. App. D.C. 1980).

[39] *Id.* at 111; *see also Gerstner Elec., Inc. v. American Ins. Co.*, 520 F.2d 790 (8th Cir.1975); *Cox v. Process Eng'g, Inc.*, 472 S.W.2d 585, 587 (Tex.Civ.App.-Amarillo 1971, no writ); Restatement (Second) of Torts §§ 766, 766A (1979). "Prior to default, a surety does not have a unilateral right to intervene in a contract dispute between an owner and a principal unless the indemnity agreement between the surety and principal provides otherwise". Robert F. Cushman, et al., *Representing the Performance Bond Surety, in* Construction Defaults, *supra*

Other actions of the obligee that sound in "prejudice to the surety" may warrant a discharge of the surety or otherwise limit its performance bond obligations. One such situation may occur when the obligee fails to timely terminate the principal and makes claims for delay damages against the surety. Based on the foregoing discussion, a substantial delay by an obligee in terminating or defaulting a poorly performing principal would be prejudicial to the surety where the obligee seeks recovery of delay damages, such as liquidated damages. Under such circumstances, prejudice might be established by comparing and/or showing the disparity in the percentage of the work under the contract completed versus the percentage of the contract time elapsed.

D. Failure to Mitigate

A common situation giving rise to a mitigation of damages defense in favor of the surety is one in which the obligee takes over the project for completion purposes without advising the surety and/or affording the surety an opportunity to takeover the project to completion. In 1997, the Federal District Court in Connecticut held that an obligee's failure to declare the bond principal in default and allowing the surety to complete the project operated as a release of the surety.[40] Accordingly, when an obligee fails to notify the surety of a principal default, the surety is not afforded the opportunity to investigate and decide whether to takeover the project or to fund the obligee under the bond for the cost to complete. A failure to provide notice to the surety will normally result in the surety's obligations being discharged to the extent of its prejudice.

CONCLUSION

The reviewed authorities make it abundantly clear that the modern compensated surety will rarely escape complete liability because of a material change in the relationship between the obligee and its principal. The surety can, however, rely on establishing at least a *pro tanto* release to the extent it can meet its burden of proof as to the prejudice it suffered as a result of such a change.

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note 11, § 5.2, at 106.

[40] *Balfour Beatty Const., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997).