

INTRODUCTION

The scope of this article will be an examination of the use of the Cardinal Change Doctrine for the purpose of discharging the obligations of a compensated surety. Brief consideration will also be given to defenses arising from material alterations to the undertakings of the underlying contract of a payment or performance bond and also to the impact of broad Changes Clauses to those defenses.

A surety's legal obligation is contractual in nature and is limited to the specific terms of the surety bond and the intent of the parties thereto.¹ The underlying contract is generally incorporated into the bond and the terms of the contract and the bond are then construed together as a whole to ascertain the intent of the parties.² Therefore, the surety's obligation to assure payment and/or performance is generally limited to the contractual undertakings between the principal and the obligee and the issue that needs to be addressed is what impact alterations to these contractual undertakings subsequent to the execution of the surety bond have upon the surety's obligations.

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ALTERATIONS TO THE PRINCIPAL'S UNDERTAKINGS

Generally, in the absence of contractual provisions that provide otherwise, a compensated surety is discharged from its obligations if a material modification occurs in the principal's undertaking.³ A material modification is generally defined as one that a careful and prudent person undertaking the risk would regard as substantially increasing the chance of loss.⁴ Therefore, if the underlying contract to the surety bond is materially altered without the surety's consent, the surety is generally discharged on the theory that it only insured those risks that existed pursuant to the terms of the original contract.⁵

Regardless of the materiality of the modification, a surety's right to object to a modification is governed by the surety agreement. If the surety agreement binds the surety to the type of modification proposed, the surety will not be able to seek a discharge of its obligations as a result of the subsequent modification. As an example, if the surety bond secures the project "to the satisfaction of the government," the surety will be liable for all modifications that could be reasonably required by the government.⁶

As discussed above, the underlying contract and its terms and conditions are generally incorporated into the surety

bond. Therefore, any modifications to the undertakings, regardless of their materiality, which fall within the scope of a broad Changes Clause would generally not discharge the surety of its obligations. However, the case law interpreting such clauses clearly establishes that not every change or series of changes falls within the general scope of the contract.⁷

CARDINAL CHANGE DOCTRINE

Those changes that fall outside the scope of the original contract are referred to as cardinal changes and can be relied upon by a surety to discharge its obligations. The United States Court of Claims has defined a cardinal change as a drastic modification beyond the scope of the original contract and identified the standard to be whether the modified job was essentially the same work as the parties bargained for when the original contract was executed.⁸ In another case, the Court of Claims held that a cardinal change occurs when an obligee requires an alteration in the undertakings of the original contract that is "so drastic that it effectively requires the contractor to perform duties materially different than originally bargained for."⁹ When a court determines that the change in the principal's undertaking is the type contemplated by a contractual Changes Clause, the remedy available to the principal is an equitable adjustment to the

contract price under the Changes Clause. However, when the change in undertaking is so significant that the court determines that it is a cardinal change, it is not redressable under the contract and the remedy is for breach of contract.¹⁰

Whether a change in the principal's undertaking rises to the level of a cardinal change is a factual determination that must be considered on a case by case basis.¹¹ The Court of Claims has identified a non-exhaustive list of factors to be considered in determining if a cardinal change has occurred including: the number of changes; the parts of the job that were changed compared to the parts of the job that were unchanged; the effect of the changes on the unchanged parts of the job; the character of the changes; the timing of the changes; the extent of engineering, research, and development the plaintiff had to do as a result of the changes; and the cost of the changed item as compared to the original contemplated item.¹² In another case, the Court of Claims held that "the number of changes is not, in and of itself, the test by which it should be determined whether or not alterations are outside of the scope of a contract. This court decided . . . that the government had not breached a construction contract in which it had made 62 separate changes. On the other hand, obviously, a single change which is beyond the scope of a contract may be serious enough to constitute an actionable breach of that contract."¹³

Saddler v. The United States¹⁴ is a case that exemplifies the factual determination of whether a change is significant enough to constitute a cardinal change. The Claims Court held that the change orders issued by the defendants, which doubled the scope of work under the original contract, rose to the level of a cardinal change, thereby allowing the plaintiff recovery for the associated expense with the extra work. The plaintiff had entered into a contract to construct a levy embankment on a river. Shortly after beginning the work a severe flood forced abandonment of the work site. As a result of the flood, it became apparent that a levy built to the specifications called for in the original contract would be inadequate to withstand a subsequent flood of the same magnitude. Therefore, the defendant issued a change order pursuant to the Changes Clause in the contract effectively doubling the size of the levy to be constructed. The plaintiff, relying on the Cardinal Change Doctrine, brought an action for breach of contract claiming the change specifications were outside the scope of the original contract.

The government maintained that the change order did not alter the quality, character, nature, or type of work contemplated by the contract and insisted that the change order was actually designed to achieve the original purpose of the

contract. The court, stressing that a single change which is beyond the scope of the original contract can be serious enough to constitute an action for breach, held that the variance which resulted from the change order was not within the reasonable limits of the Changes Clause and that a cardinal change had occurred. The court, recognizing that the construction of a levy was, in fact, the contemplation of the parties, stressed that the change order which doubled the amount of the work required changed the nature of the original contract to the extent that a cardinal alteration of the scope of the original contract had occurred.

Similarly, in Westinghouse Electric Corporation v. Garrett Corporation¹⁵ the court held that where a contractor failed to provide a subcontractor with source control drawings to aid the subcontractor in design requirements under the controlling contract, the contractor was in breach of contract pursuant to the Cardinal Change Doctrine. The court stressed that while the prime contractor maintained that it had provided the necessary information through alternative sources other than the source control drawings, the character of this change was such as to fundamentally alter the nature of the subcontractor's undertaking and, therefore, was, in fact, a cardinal change. There were expansive Changes Clauses in both Saddler and Westinghouse and both cases reflect instances where a court determined that a change was outside the scope of the Changes Clause and the obligee was in breach of contract.

SURETY'S RIGHT TO RAISE PRINCIPAL'S DEFENSES

A surety generally may avail itself of any defense which its principal may have except purely personal defenses (ie. bankruptcy or infancy).¹⁶ Therefore, in those instances where a surety is called upon to perform after a principal's default and there has been significant changes to the original undertaking the surety has the Cardinal Change Doctrine as an available defense.¹⁷

Employer's Insurance of Wausau v. Construction Management Engineers of Florida, Inc.¹⁸ is a case where a surety was discharged from the obligations of its bond based upon a substantial change of risk in the undertakings of the original underlying contract. While the court did not specifically address the Cardinal Change Doctrine, the court's analysis was conceptually similar to the reasoning of the cases discussed above. In this case, the contractor executed a contract with a subcontractor which required the subcontractor to perform all work for the proposed project except general management of the project and 12 specific areas of construction. The subcontract was for an approximate amount of \$2.3 million. This subcontract required the subcontractor to obtain a payment and performance bond for \$2.3 million and a bond was obtained from the plaintiff

surety. A day after the first contract was executed, a second contract was executed by the same contractor and subcontractor which required the same subcontractor to perform "all work of every nature for the complete project." The second contract was for an original amount of approximately \$6.2 million and had a provision which superseded any prior agreements or proposals between the parties. The plaintiff surety was not aware of the second contract until after the subcontractor defaulted. The surety then refused to perform under the payment and performance bond and brought a declaratory judgment action seeking to be discharged from the obligations of the bond. The trial court granted summary judgment to the surety holding as a matter of law that the surety was discharged from the obligations of the bond because the second contract superseded the first contract and also because the risk of the surety was substantially increased. The contractor appealed, and the appellate court upheld the trial court finding that the change and risk under the second contract discharged the surety as a matter of law.

CONCLUSION

As discussed above, the obligations of a surety under a payment and performance bond are contractual in nature and are generally limited to terms and conditions of the surety bond and the underlying contract which is generally

incorporated into the bond. Because of the inclusion of broad Changes Clauses in construction contracts (and similar provisions in surety bonds as well), an obligee generally has considerable latitude in requiring changes in the undertakings of the original contract. In those instances when the changes fall within the scope of the original contract pursuant to the Changes Clause, the remedy to the principal (to which a surety is equitably subrogated) is an equitable adjustment in the original contract price. However, in those instances where subsequent changes to the undertakings are so significant as to alter the fundamental scope of the original contract, the obligee will be held to have breached the contract pursuant to the Cardinal Change Doctrine. In those instances, the remedy to the principal and to the surety is a breach of contract remedy that falls outside of the original contract. Because a surety has the right to raise principal's defenses, courts recognize the right of a surety to seek discharge of its obligations because of cardinal changes to the contract that underlies the surety bond.

1. Employers Insurance of Wausau v. Construction Management Engineers of Florida, Inc., 377 S.E. 2d 119, 121 (S.C. Ct. App. 1989).
2. Id.
3. Restatement of Security, § 128: "Where, without the surety's consent, the principal and the creditor modify their contract otherwise than by extension of time . . .
(b) the compensated surety is
 - (i) discharged if the modification materially increases his risk, and
 - (ii) not discharged if the risk is not materially increased but his obligation is reduced to the extent of loss due to the modification."
4. Samuelson v. Promontory Investment Corp., 736 P.2d 207, 210 (Or. Ct. App. 1986).
5. Argonaut Insurance Company v. Town of Cloverdale, 699 F.2d 417, 419 (7th Cir. 1983).
6. Pacific City v. Sherwood Pacific, Inc., 567 P.2d 642, 649.
7. Westinghouse Electric Corporation v. The Garrett Corporation, 437 F. Supp. 1301, 1332 (Md. 1977).
Air-A-Plane Corporation v. The United States, 406 F.2d 1030 (Ct. of Cl. 1969).
8. Air-A-Plane Corporation 406 F.2d at 1033.
9. Allied Materials and Equipment Company, Inc. v. The United States, 569 F.2d 562, 563 (Ct. of Cl. 1978).
10. Air-A-Plane Corporation 406 F.2d at 1033.
11. Id.
12. Id. at 1037.
13. Saddler v. The United States, 287 F.2d 411, 413 (Ct. of Cl. 1961).
14. Id.
15. 437 F. Supp. 1301 (D.Md. 1977).
16. 72 C.J.S. § 189. See also Rhode Island Hospital Trust National Bank v. The Ohio Casualty Insurance Company, 613 F.Supp. 1197 (D.R.I. 1985); National Union Fire Insurance Company of Pittsburgh, Pennsylvania v. Alexander, 728 F.Supp. 192 (S.D.N.Y. 1989). United States Fidelity and Guaranty Co. v. Miami Sheet Metal Products, Inc., 516 So.2d 29 (Fl. 3d D.C.A. 1987).

17. United States v. Seaboard Surety Company, 622 F. Supp. 882 (E.D.N.Y. 1985) (Where the Court recognized the cardinal change defense raised by the surety but refused to grant summary judgment in favor of the surety holding that whether there was a cardinal change was a clearly disputed issue of material fact and would require trial).
18. 377 S.E.2d 119 (S.C. Ct. App. 1989).

