

**SIXTH ANNUAL  
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***GROUNDS FOR DISCHARGE OF  
SURETY'S OBLIGATION TO OBLIGEE***

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Numerous courts throughout the country have addressed the relationship among sureties, principals and obligees. However, there is little consensus concerning the law of suretyship defenses.

Depending on the facts of each case, circumstances may arise which afford a surety a complete defense to a claim made by an obligee. This paper addresses some of the more common defenses which a surety might raise. Of course, these defenses will not exist in every case, and a surety must be very careful in aggressively asserting these defenses. However, in the proper case, these defenses can provide the surety with a valuable weapon against claims brought by an obligee.

#### **1. STATUTES OF LIMITATION**

Many states have statutes of limitation which provide that certain actions cannot be brought under a bond within a certain period of time after substantial completion. Since different states have different statutes of limitation, this paper does not address the relevant case law. However, it is essential for sureties to be familiar with the applicable statute of limitations.

#### **2. MATERIAL ALTERATION TO CONTRACT**

A surety's decision as to whether to issue a bond usually depends on a risk assessment. The surety must have some comfort level with the obligor and the task he has agreed to perform. Occasionally, the obligee engages in conduct which alters the risks that the surety originally assumed.

Sureties have historically been discharged when changes were made in the contracts which underlie the bond. This doctrine is commonly known as *strictissimi juris*. However, the strict application of this doctrine resulted in windfalls for sureties that were not actually prejudiced by minor changes in the underlying obligation. Therefore, the modern trend is that this doctrine does not apply to compensated sureties. In fact, many bonds now provide that a surety will remain liable despite minor changes in the underlying contract.

The surety can be released if the changes to the principal's obligations are so material or substantial as to amount to a departure from the original contract, or if the changes alter the original undertaking or the scope of the obligation so as to materially increase the surety's risk. Continental Bank and Trust Company v. American Bonding Co., 605 F.2d 1049 (8th Cir. 1979); Restatement of Securities, § 128(b) (1941). Board of Supervisors of Fairfax County v. Southern Cross Coal Corporation, 380 S.E. 2d 636, 638 (Vir. 1989). Mere immaterial or technical departures from the contract which do not result in damage to the surety will not release the surety. Ramada Development Company v. United States Fidelity and Guaranty Company, 626 F.2d 517, 521 (6th Cir. 1980).

Even if the surety can establish that a material change has occurred, the modern trend is to require the surety to also show that it has been prejudiced before allowing a discharge. Mergentime Corporation v. Washington Metropolitan Area Transit Authority, 775 F. Supp. 14 (Dist. D.C. 1991); Ramada Development Co. v. United States Fidelity and Guaranty Company, 626 F. 2d 517 (6th Cir. 1980); Anstalt v. F.I.A. Insurance Company, 749 F.2d 175 (3d Cir. 1984).

Courts will not simply discharge a surety when it claims that the underlying obligation has changed. For instance, in Basic Asphalt and Construction Corporation v. Parliament Insurance Co., 531 F.2d 702 (5th Cir. 1976), the prime contractor was given an extension of time to make payments to the subcontractor. This extension was given without the surety's consent. Id. at 703. However, absent some showing of prejudice to the surety, the mere extension of time would not discharge the surety. Id. at 703-704.

Nonetheless, in the right circumstances, this defense can be powerful. For example, in United States of America v. Reliance Insurance Co., 799 F.2d 1382 (9th Cir. 1986), the court affirmed a summary judgment in the surety's favor due to material modifications to the contract which prejudiced the surety. Id. at 1383. Reliance had issued a bond securing monies to be paid by the Army-Navy '83 Foundation (the "Foundation") to Army and Navy (the "Academies") from the annual Army-Navy

football game. Certain monies were not paid by the Foundation to the Academies, and suit was brought against Reliance on behalf of the Academies. Reliance claimed that the underlying contract between the Academies and the Foundation was modified to its prejudice. *Id.*

The bond guaranteed the Foundation's obligation to pay monies to the Academies. Pursuant to the original contract, the Foundation was to make the payments to transport the cadets and midshipmen to the game. However, when the Foundation was unable to make this payment, the parties modified the contract by having the Academies provide the necessary funds. In return, the Foundation waived its right to ticket revenues for the game. *Id.* at 1384. This modification to the contract was made without Reliance's knowledge. The court noted that as a general rule, a surety will be discharged where the bonded contract is materially altered or changed without the surety's knowledge or consent. *Id.* at 1385.<sup>1</sup> However, Reliance had to also show that the modifications resulted in some prejudice to it. *Id.*

Reliance had relied on the Foundation's right to the television proceeds as provided in the original contract, and the contract modification deprived the Foundation of these television revenues. Absent these revenues, Reliance would likely have determined the risk was too great and declined to issue the bonds. *Id.* at 1386.

Importantly, the modifications to the contract must be more than merely additional work. In *Wagner v. Frazier*, 712 S.W. 2d 109 (Tenn. App. 1986), the principal unexpectedly discovered rock during its excavation of the property and had to perform extra work. As a result of this extra work, the principal defaulted and the obligee sought payment from the surety. The surety raised the defense that the additional work discharged the surety's obligation on the bond. *Id.* at 116. The court disagreed and held that the changes in the scope of the work did not materially increase the risk to the surety.

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<sup>1</sup> The court noted that it is not for the contracting parties to decide whether modifications are of interest to the surety. *Id.* at 1386.

Discharging the surety in these circumstances would result in a situation where "extras" were never permitted under contracts. Id.

While a material change in the contract without the surety's consent may release the surety from its obligations under a bond, a surety often gives advance consent to certain changes by the terms of the bond itself. Additionally, the bond may provide that the surety has no right to receive notice of modifications to the contract. Mergentime Corporation vs. Washington Metropolitan Area Transit Authority, 775 F. Supp. 14, 21 (D.C. 1991). The surety can also give consent to changes by simply ignoring a request to consent to a contract change. In other words, the surety's consent need not be in writing in order to bind the surety. Public Service Electric and Gas Company v. Technology for Energy Corporation, 140 B.R. 214, 217 (E.D. Tenn. 1992.).

Obviously, a surety is in a better position if the bond does not allow for alterations to the contract without the surety's consent. Vastine v. Bank of Dallas, 808 S.W.2d 463 (Tex. 1991). In fact, a bond may allow a surety to terminate its obligations upon any changes to the contract and without the necessity of establishing that it has been prejudiced. Premier Bank, National Assoc. v. Mosbacher, 959 F.2d 562, 567 (5th Cir. 1992).

### 3. OVERPAYMENT.

In a variation to the material alteration cases, sureties are often prejudiced when an obligee makes unauthorized payments to a principal who later defaults. Subsequently, the obligee seeks reimbursement from the surety. When this occurs, the surety may claim that it should be discharged to the extent of the improper payment.

Courts have held sureties to their burden of establishing that they have been prejudiced by the improper payments. In Mergentime Corporation vs. Washington Metropolitan Area Transit Authority, 775 F. Supp. 14 (D.C. 1991), the surety issued performance and payment bonds to the contractor who was constructing portions of the Washington Metropolitan Transit. The court recognized that a surety

is discharged if the obligee makes unauthorized payments to the principal, or if the contract the surety has guaranteed is altered without the surety's consent. *Id.* at 19. However, the court recognized that the modern trend requires a showing of prejudice to the surety in addition to the material modification to the underlying contract. *Id.* The court cited Restatement of Securities § 128(b), comment f (1941), which states in pertinent part:

"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 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."

In Mergentime, \$3,000,000 of the \$6,000,000 paid to the contractor/principal was an overpayment. As a result, the contract balances left for completion of the projects were diminished by \$3,000,000. The surety therefore claimed that it was entitled to a discharge from its bond obligations to the extent of \$3,000,000. However, the court did not grant the surety a summary judgment because there was a factual issue as to whether the surety was prejudiced by the alleged overpayment. *Id.* at 22.<sup>2</sup> (But see, Southwood Builders, Inc. v. Peerless Insurance Company, 366 S.E. 2d 104 (Vir. 1988), where the court held that a separate showing of prejudice to the surety was unnecessary because the obligee's unauthorized payments established sufficient prejudice in and of itself. *Id.* at 108).

Overpayments will not always result in the discharge of the surety. For instance, in Argonaut Insurance Company v. Town of Cloverdale, Indiana, 699 F.2d 417 (7th Cir. 1983), the obligee made advance payments to a principal that were beyond those provided for in the contract. The obligee argued that a surety is not discharged by reason of unauthorized payments made in good faith reliance on an engineer's certificate of progress. *Id.* at 419. It was difficult for the surety to establish prejudice

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<sup>2</sup> The owner also made improper prepayments of retainage funds to the contractor/principal. Again, the surety claimed that it was discharged to the extent of this improper prepayment. However, the court held that this was not automatic grounds for a discharge, and that genuine issues existed as to whether the surety was actually prejudiced by the unauthorized prepayment of retainage funds. *Id.* at 23.

where the prepayments were not pocketed by the contractor, but were instead used to buy materials for the project. *Id.* at 419 - 420. Since the contract allowed progress payments to be made based upon approximate estimates, the payment based on the overestimates was not a breach of the contract or a material alteration of which the surety could complain. *Id.* at 420.

Similarly, in Transamerica Insurance Company v. City of Kennewick, 785 F.2d 660 (9th Cir. 1986), the obligee made overpayments to the principal and the surety argued that its security was impaired and that these payments were a material alteration of the agreement. *Id.* at 661. The court recognized that improper advance payments could prejudice a surety by depriving the surety of the security that the obligee agreed to hold for its benefit, and by reducing the contractor's incentive to finish the work according to the contract. However, the mere fact of a premature payment does not automatically mean that a surety has been prejudiced. *Id.*

Despite unauthorized advance payments, sureties remain liable when such payments were made reasonably and in good faith. *Id.* In Transamerica, the obligee acted reasonably because the payments were made in good faith for materials that were at the construction site and paid for by the contractor. Further, the obligee was simply compromising a disagreement with the principal and was protecting itself and the surety from additional financial exposure. *Id.* at 662.

#### 4. FRAUD/FAILURE TO DISCLOSE

If the obligee knows that a material part of a transaction is being misrepresented to the surety, the misrepresentation being such that but for the same having taken place the suretyship would not have been entered into, or the extent of the surety's liability might have been increased, the surety is discharged. Lambert v. Heaton, 134 So. 2d 536 (Fla. 1st DCA 1961); Plant Process Equipment v. Continental Carbonic Products, 1994 LEXIS 6459 (N.D. Ill. May 16, 1994). Likewise, if facts material to the surety are concealed by the obligee when it is his duty to disclose them, his motive in concealing the facts is immaterial. Lambert, *infra* at 539; National Union Fire Insurance Company of Pittsburgh,

PA. vs. Robuck, 203 So. 2d 204 (Fla. 1st DCA 1967). If the creditor has reason to believe that the misrepresented facts are unknown to the surety, failure to notify the surety of such facts can be a defense to the surety. Sumitomo Bank of California vs. Iwasaki, 447 P.2d 956 (Cal. 1968).

In Rachman Bag Company v. Liberty Mutual Insurance Co., 46 F.3d 230 (2d Cir. 1995), the court addressed the issue of fraud with respect to the obligee's relationship with the surety. In Rachman, the bond purported to secure a normal business transaction between the principal and obligee. The bond was issued to secure payment from the principal to the obligee. However, the source of the principal's indebtedness to the obligee stemmed from the fact that the principal had stolen from the obligee on prior occasions. Id. at 4. When the principal defaulted and the obligee demanded payment on the bond, the surety raised the defense of fraudulent concealment. Id. at 5.

In reversing a summary judgment that had been entered in the surety's favor, the court concluded that there was a fact issue as to whether the obligee had a duty to disclose the relevant information to the surety. Id. at 6. The court noted that generally, sureties have the duty "to look out for themselves and ascertain the nature of their obligations." Id. at 6. Sureties must usually take the initiative and inquire about information they deem important. However, when a surety does request information from an obligee, the obligee's silence can amount to fraudulent concealment. Id.

In applying New York law, the court noted that absent a request from the surety, the obligee's silence will only amount to fraud where the obligee had a duty to disclose what it allegedly withheld. Id. Merely knowing information that would be material to the surety does not itself give rise to an affirmative duty to disclose it. Id.

In discussing whether the obligee had the duty to disclose material information to the surety, the court held that such a duty would arise when the obligee deals directly with the surety in obtaining the bond, or where the obligee's silence would amount to an affirmative misrepresentation (i.e., where the obligee affirmatively created a misimpression, it has the duty to correct it). Id. at 7. Additionally, if

the principal misleads the surety, the obligee may be obligated to disclose facts if it colluded in the deception. Id.

Under New York law, the test for fraudulent concealment by an obligee consists of four elements: 1) the obligee knows of facts that materially increase the surety's risk; 2) the obligee has reason to believe such facts are unknown to the surety; 3) the obligee has the opportunity to communicate the relevant information to the surety; and 4) the obligee has the duty to disclose the information based upon its relationship to the surety, its responsibility for the surety's misimpression, or other circumstances. Id. at 8.

In reversing the summary judgment for the surety, the court held that there were factual issues as to whether sufficient circumstances existed to trigger a duty on the obligee's part to disclose to the surety the fact that the principal had previously stolen from the obligee. Id.

If raising a defense based on the failure to disclose, the surety must be certain that the duty of disclosure runs to the surety as opposed to the principal. When a surety learns of material facts which existed at the time the bond was written, and the surety was uninformed of such facts, the surety should give strong consideration to a fraud defense.

## 5. BREACH OF CONTRACT

In performance bond scenarios, obligees will occasionally breach the contract with the principal, thereby causing the principal to default on the project. Subsequently, the obligees will sue the surety. In such a situation, the surety may raise the defense of breach of contract.

In Sage Street Associates, 3525 v. Northdale Construction Company, 809 S.W. 2d 775 (Ct. App. Tex. 1991), the bond provided that the surety was not liable unless the obligees made payments to the principal strictly in accordance with the contract, and performed all other obligations to be performed under the contract. Id. at 778. The principal left the project after the obligee breached the contract by failing to make certain payments. Id. at 777. The jury found that the obligee wrongfully terminated

the principal. Id. at 776. Since the jury found that the obligee did not perform its obligations under the contract, the surety was properly relieved from performance on the bond. Id. at 778.

Even though a surety may raise the defense that the obligee committed a material breach, a surety may be bound by the dispute resolution procedures which govern the contract between the principal and obligee. In Granite Computer Leasing Corp. v. Travelers Indemnity Company, 894 F.2d 547 (2d Cir. 1990), the owner obtained a general contractor to build homes. The contractor agreed to abide by a dispute resolution clause that obligated it to continue work pending the resolution of disputes. Id. at 550. The contractor entered into a subcontract, and the subcontractor obtained a surety which named the general contractor as the obligee. Id. Due to numerous delays caused by the owner, the subcontractor abandoned the job and the surety refused to complete the job. Id. at 549. When the contractor's assignee filed suit against the surety to recover the cost of completion, the surety claimed that the subcontractor was justified in abandoning the project, and that the obligee had materially breached the contract. Id. at 551.

The court held that the subcontractor's abandonment of the project was a breach of contract because the subcontractor was bound by the "disputes clause" to continue working on the project pending resolution of any claim. Id. at 550. However, the court also noted that if the dispute resolution procedure failed as a result of the obligee's breach of the dispute resolution duty, then the subcontractor's and surety's duty to perform would be discharged. Id. at 552 - 553.

#### **6. NOTICE TO SURETY**

A surety can sometimes defend an obligee's claim by raising the defense that no notice was ever given to the surety prior to the lawsuit. In determining the effect of the failure to give notice, it is essential to determine whether the bond contains a notice requirement. Generally, an owner's failure to give notice to the surety of the principal's default will not discharge the surety unless the bond specifically provides for such notice. Elkins Manor Association v. Eleanore Concrete, 396 S.E. 2d 463,

470 (W.Va. 1990). In L&A Contracting Company v. Southern Concrete Services, 17 F.3d 106 (5th Cir. 1994), the bond imposed liability on the surety only if the principal defaulted and the obligee declared to the surety that the principal was in default. Id. at 109. The court stated that:

"The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of the bond. Id. at 111."

In vacating a judgment entered against the surety, the L&A Court found that none of the correspondence from the obligee to the surety established a declaration of default. Id.

Similarly, in Town of Clarkstown v. North River Insurance Company, 803 F.Supp. 827 (S.D.N.Y. 1992), the principal defaulted on the project and the obligee brought an action against the surety. Id. at 828. The court rejected the obligee's argument that it had no duty to notify the insurer. Even where no notice provisions are in an insurance instrument, the law implies an obligation that the obligee notify the insurer of a claim within a reasonable time. Id. at 829. The requirement of timely notice ensures that an insurer will be in the best possible position to reduce the cost of the claim. Therefore, failing to provide notice should result in a reduction in the sum owed in an amount which would offset the prejudice incurred. Id. at 829-830. However, despite this ruling, the surety was not able to present evidence indicating that it had been prejudiced. Id.

In Sherry and O'Leary, Inc. v. Tom Mistick and Sons, Inc., 148 B.R. 248 (W.D. Penn. 1992), the surety raised the defense that it did not receive timely notice of the principal's default. Id. at 255. The court noted that a creditor is not required to give notice to the surety, and that failure to give notice will discharge the surety only where the contract of suretyship requires such notice. Id. Because no such notice clause existed and the surety could not show any prejudice, the defense was inadequate. Id. at 255-256.

In Continental Bank and Trust Company v. American Bonding Co., 605 F.2d 1049 (8th Cir. 1979), the court recognized that in the absence of a bond provision requiring notice to the surety upon the principal's default, the surety is not discharged by the obligee's failure to communicate such notice. However, the obligee may not delay before notifying the surety and insist on recovering damages which accrued between the default and the time that actual notice was given. Id. at 1057.

7. **CONCLUSION**

The cases cited above should give sureties some guidance in determining when defenses might be raised that will act as a complete discharge to an obligee's claim. While a surety should be cautious in aggressively asserting these defenses, the lack of consensus in the case law will allow for some creativity on the surety's part. However, the more recent cases do appear uniform in holding that in order for a surety to be discharged, it must establish that it has been prejudiced.