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INTRODUCTION AND LEGAL BACKGROUND TO THE MATERIAL ALTERATION DOCTRINE

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The wise have warned of the consequences of unexpected risks arising from a surety obligation, coupled with the potential for financial disaster, since antiquity: “Being surety has ruined many who were prosperous, and has tossed them about like waves of the sea; it has driven the influential into exile, and they have wandered among foreign nations.”¹ Such dire warnings were apropos, especially in a time when suretyship involved personal guarantees that work would be performed and at times even involved the offering of oneself as a hostage pending performance of a duty by another.² A change in the surety’s obligation and the accompanying risks could prove disastrous, not only to sureties’ wealth but to their very lives.

For these and other less dramatic reasons, certain legal protections developed to mitigate those risks. For example, the Roman Lex Cicereia provided that a surety would be discharged unless a creditor had publicly declared the nature of the principal obligation prior to entering a contract of suretyship.³ That public declaration highlights one of the critical components of a surety’s initial analysis of its secondary obligation: the surety’s ability to rely upon a defined, unchanging risk in connection with the principal obligation. That principle is the seed of the modern material alteration doctrine. Alterations to the principal’s obligations that fundamentally alter the bonded risk, or that increase the risk of loss to the surety, can support a material change defense and lead to a partial or complete discharge of the surety’s obligation.

A. History of the Discharge Doctrine

Historically, sureties entered into surety obligations based on their friendship or familial ties with the principals.⁴ These voluntary sureties were individuals and groups of individuals who usually had no pecuniary interest in the principal’s obligation and who simply offered their personal guarantee without compensation. The principal’s default potentially created great hardship on such a voluntary (or accommodation) surety. A surety therefore enjoyed preferred status as a favorite under the law.⁵

Due to the personal nature of suretyship, the surety was presumed to be familiar with the terms of the agreement to which it was bound, the nature and feasibility of the work to be performed, and the ability of the principal to carry out its underlying obligation to the obligee.⁶ The surety had the right to rely on the “exact terms” of the underlying obligation and to expect that no changes would be made without the surety’s consent.⁷ Accordingly, under the traditional approach, courts applied the principle of strictissimi juris—strict interpretation—and a surety was discharged from its obligations if there was any change in the bonded obligation, regardless of whether the change inured to the surety’s benefit.⁸ In a time before sureties were compensated, this made perfect sense,

¹ Ecclesiasticus 29:14-19.
³ Id. at 159.
⁴ See Lackland v. Renshaw, 165 S.W. 314, 315 (Mo. 1914).
⁵ First Nat’l Bank v. Livermore, 133 P. 734, 736 (Kan. 1913); Morgan, supra note 2, at 159.
⁷ Id. at 425.
⁸ Id. at 425-26; Miller v. Stewart, 22 U.S. 680, 702-04 (1824).
as it would be wholly inequitable to hold a non-compensated, volunteer surety liable for obligations it did not contemplate when it agreed to be bound. Indeed, the non-compensated surety is still a favorite of the law and may generally only be held to the strict terms of its obligation.9

A shift of sorts began to occur through the 19th and early 20th centuries with the emergence of the corporate, compensated surety. Courts recognized that the compensated surety should be expected to be more sophisticated than, say, a farmer who put up security for his neighbor’s crops10 or a family member who offered himself as a guarantee for debt. The corporate surety presumably had the wherewithal to evaluate the more complex business transactions involved in the primary obligation and to assess the concomitant risk of relatively minor changes to the underlying obligation. And from a practical standpoint, a strict rule of discharge arguably did not benefit the corporate surety industry in the first place. The compensated surety's ability to obtain a discharge based on any alteration to the bonded contract became overly inclusive when an obligee, for fear of extinguishing the bond, could not make minor changes to the contract. While it could lead to a potential windfall for the surety in that single instance of change followed by default, bonds themselves would be less desirable with the risk of complete discharge upon minor changes to the agreement. The rise of the compensated surety and its guarantee of more complex business transactions called for a less strict approach.

In modern times, the rule of strictissimi juris has been mitigated in two ways. First, although sureties are still in many respects favorites of the law, courts distinguished the compensated surety from the accommodation surety in the discharge analysis and began to move away from a blanket policy of complete discharge when any change to the bonded obligation occurred. This change manifested in courts in a requirement that the surety demonstrate injury or prejudice prior to discharge, which was either shown directly or presumed based on the materiality of the alteration.11 In sum, the courts concluded that when a corporate surety writes a bond for profit, the rule of strictissimi juris ought not to be stringently applied.12 Within the industry itself, a second mitigating factor arose: obligees and sureties began incorporating provisions in their contracts and bonds allowing for minor changes to occur without discharging the surety.13 This practice created a degree of flexibility even within the restraints of the strictissimi juris doctrine. With these developments, the principals who obtained bonds and the obligees who ultimately bore the cost gained some versatility that reflected the reality of the changing demands of commerce.

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10 One of the first surviving records of a surety contract—a merchant’s agreement to be guarantee a farmer’s cultivation and care of another farmer’s land while the landowner was called to military service—dates back over 4,000 years to the reign of Sargon 1. Morgan, supra note 2, at 153.
11 Arant, Rationale of the Rule That an Obligee’s Premature Payment Discharges His Surety, 80 U. Pa. L. Rev. 842, 845 (1932).
12 Pressed Brick Co., 191 U.S. at 426.
Although corporate sureties have adapted to meet the needs of commerce, sureties are no less concerned today with avoiding risks substantially different from its original obligation than voluntary sureties were. While the corporate surety is often more sophisticated than the individual accommodation surety, the corporate surety is not a fortune teller and does not become a blanket insurer upon issuance of a bond. The general rule remains that where the contract has only one meaning, the compensated surety’s obligation may not be extended beyond the terms of the contract either by construction or implication to its prejudice.¹⁴ “A contract of suretyship will be strictly construed so as to impose on the surety only such burdens or obligations as clearly come within the terms of the contract. . . .”¹⁵ While today’s compensated sureties may no longer expect to enjoy a “sacrosanct prohibition of change,”¹⁶ a material alteration to the bonded contract made without the surety’s knowledge or consent may nonetheless discharge the surety.¹⁷

B. Related Doctrines

The material alteration doctrine did not develop in a vacuum, and it shares similarities and rationales with other legal doctrines. The foundational concept that a surety should not be bound to a contract fundamentally different from the original obligation finds its parallel in the cardinal change doctrine. And the consequences of a material alteration—the prejudice to the surety—are often reflected in the impairment of collateral doctrine.

1. Cardinal Change

The “fundamental change” aspect of the material alteration doctrine is conceptually similar to the cardinal change doctrine. The cardinal change doctrine comes into play when an owner or outside factors dictate an extreme change to the contract not within the reasonable expectations of the parties. A cardinal change may be considered a breach of the contract.¹⁸ The doctrine applies in both public and private contracts depending upon the jurisdiction, with additional justifications specific to procedures in the arena of government contracting.¹⁹ The cardinal change doctrine was described well in Atlantic Dry Dock Corp. v. United States in the setting of a dispute regarding a government contract:²⁰

[A cardinal change] occurs when the government effects an alteration in the work so drastic that it effectively requires the contractor to perform duties materially different from those originally bargained for. By definition, then, a cardinal change is so profound that it is not redressable under the contract, and thus renders the government in breach.

¹⁵ Bill Curphy Co. v. Elliott, 207 F.2d 103, 108 (5th Cir. 1953) (quoting Standard Accident Ins. Co. v. Knox, 184 S.W.2d 612, 615 (Tex. 1944); see also Old Colony Ins. Co. v. City of Quitman, 352 S.W.2d 452, 455 (Tex. 1961).
¹⁶ USF&G v. Braspetro Oil Services Co., 369 F.3d 34, 61 (2d Cir. 2004).
¹⁷ United States ex rel Army Athletic Asso. v. Reliance Ins. Co., 799 F.2d 1382, 1385 (9th Cir. 1986).
¹⁹ Id.
Allied Materials & Equip. Co. v. United States, 215 Ct. Cl. 406, 569 F.2d 562, 563-64 (Ct. Cl. 1978). The purpose of the cardinal change doctrine “is to provide a breach remedy for contractors who are directed by the Government to perform work which is not within the general scope of the contract.” In other words, work which “fundamentally alters the contractual undertaking of the contractor. . . .” Edward R. Marden Corp. v. United States, 194 Ct. Cl. 799, 442 F.2d 364, 369 (Ct. Cl. 1971).

The standard under which the cardinal change defense is evaluated was discussed in Air-A-Plane Corp. v. United States:

The basic standard . . . is whether the modified job “was essentially the same work as the parties bargained for when the contract was awarded. Plaintiff has no right to complain if the project it ultimately constructed was essentially the same as the one it contracted to construct.” Conversely, there is a cardinal change if the ordered deviations “altered the nature of the thing to be constructed.”

Similarly, the key principle of the material alteration defense is that the surety should not be bound when there is a fundamental alteration to the bonded obligations that deviates from the risk for which the surety initially agreed to be obligated.

Of course, if there is a cardinal change to a bonded contract, the surety will be discharged from its obligation because its principal is discharged. And a cardinal change to the bonded contract would also necessarily be considered a material alteration. That said, the inverse is not always true, i.e., a material alteration justifying discharge of the surety is not always a cardinal change, at least as between the principal and obligee. The changes underlying a material alteration defense are most often consensual changes to the contractual arrangements as between the principal and obligee. The cardinal change doctrine focuses on an unfair change to the underlying obligation in the contract itself, while the material alteration doctrine focuses on an unfair change to the risk the surety has undertaken with respect to the underlying contract.

2. Impairment of Collateral

Similar reasoning underpins the related impairment of collateral doctrine. A party that holds or controls collateral has an obligation to refrain from wasting, destroying, or otherwise harming collateral in its possession or injuring a guarantor’s security interest in collateral. Under the impairment of collateral doctrine, breach of that obligation discharges the guarantor to the extent of the loss.

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21 Id. at 339.
22 187 Ct. Cl. 269, 408 F.2d 1030, 1033 (Ct. Cl. 1969).
24 Id.
While this defense has broader application than just to surety obligations, it certainly can be applied to the surety relationship to reach a conclusion often very similar to when the material alteration defense is applied when the change at issue affects identified collateral of the surety. For instance, the surety is equitably subrogated to and has typically been assigned the principal’s rights in the bonded contract funds. The bonded contract funds are the most important and basic collateral available to secure the surety from loss. As such, when the acts of an obligee diminish the surety's expected recovery from the collateral—whether by loss of value of the collateral or by diminution or extinguishment of the surety's interest in the collateral—it discharges the surety to the extent of the impairment.

The doctrines of material alteration and impairment of collateral are distinct, but they may intersect or overlap. In fact, at times courts appear, intentionally or unintentionally, to conflate the two. A material change to a bonded contract justifying application of the material alteration doctrine does not always directly affect or diminish the contract funds. However, in the vast majority of cases, a material change to a bonded contract (e.g., failing to require necessary testing, failing to follow the inspection requirements of the contract, failing to adhere to the payment provisions of the bonded contract, etc.) results in an unfair diminishment of the contract funds. In fact, the stated justification for the material alteration doctrine highlights this manifestation and its importance: “the material departure from the terms of the contract deprives the surety of the inducement to perform which the contractor would otherwise have, and destroys, diminishes, or impairs the value of the securities taken.”

In jurisdictions that apply a rule of pro tanto discharge (discussed below) in connection with a material alteration, the application of the material alteration doctrine and impairment of collateral doctrine may result in the same relief. This is particularly true when the only prejudice suffered by the surety when there is a material change to the contract is a diminishment of the bonded contract funds. As discussed further below, when analyzing a material alteration defense, courts often focus (incorrectly) solely on the extent to which the contract funds were diminished when judging the prejudice to the surety and determining the extent of the discharge to be granted. This is exactly what the impairment of collateral doctrine is designed to do. That is, the impairment of collateral doctrine is designed to protect a party from the calculable diminishment of its identified collateral. However, what is often missing from the analysis of courts that conflate the two doctrines is the recognition that an alteration of the bonded contract can and typically does result in the placement of unfair burdens on the surety, albeit potentially hard to quantify, that extend well beyond the calculable decrease in the bonded contract funds. Stated another way, although often not approached as such by courts that fail to fully recognize the complexity of the surety’s completion obligations and the cascading effects on those obligations that result from a failure to adhere to the contract terms, the material alteration doctrine has much broader application and should

27 RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY §42 (AM. LAW. INST. 1996).
take account of and protect the surety from all prejudice caused to the surety by the material alteration. The impairment of collateral defense, on the other hand, focuses solely on the identified collateral and often has more limited effect in terms of the appropriate relief to be granted.

II. The Material Alteration Defense Today

The nuts and bolts of a material alteration defense are fairly straightforward. Material alteration is an affirmative defense to a bond claim, and the burden is on the surety to demonstrate that a material alteration occurred. To establish the defense, the surety generally must demonstrate the following: (1) the existence of a material alteration to the underlying bonded contract; (2) lack of the surety’s consent to the material alteration; and, in many jurisdictions; (3) harm or prejudice resulting from the material alteration. In other words, if the obligee and principal modify the underlying contract in any material degree without the surety’s consent and to the surety’s prejudice, then a new contract has effectively been formed and the surety is not bound to it. As stated in the Restatement of Suretyship and Guaranty:

(1) If the obligee acts to increase the secondary obligor’s risk of loss by increasing its potential cost of performance or decreasing its potential ability to cause the principal obligor to bear the cost of performance, the secondary obligor is discharged as described in subsections (2) . . . An act that increases the secondary obligor’s risk of loss by increasing its potential cost of performance or decreasing its potential ability to cause the principal obligor to bear the cost of performance is an “impairment of suretyship status.”

(2) If the obligee fundamentally alters the risks imposed on the secondary obligor by:

(a) releasing the principal obligor from the duty other than
the payment of money (§39(c)(iii)); or

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31 Not surprisingly, a material alteration to a contract between a bond principal and the principal’s subcontractor, i.e., a downstream contract other than the bonded contract, may not effect discharge of the surety in the performance bond context. City of Okla. City v. First Am. Title & Tr. Co., 303 P.3d 902, 907 (Ok. Civ. App. 2013). In City of Oklahoma City, the surety contended that it was discharged by material alteration of the principal’s subcontract with a subcontractor, in which the principal agreed to pay the subcontractor an additional $70,000.00 in interest. Id. at 905 n.4. The court held that the surety could only claim exoneration if it demonstrated changes in the bonded contract itself. Id.; see also Cam-Ful Indus. v. Fid. & Deposit Co., 922 F.2d 156, 161 (2d Cir. 1991).
33 Old Colony Ins. Co., 352 S.W.2d at 455.
(b) agreeing to a modification of the duties of the principal obligor that either amounts to a substituted contract or imposes risks of the secondary obligor fundamentally different from those imposed on the secondary obligor prior to modification (§41(b)(i));

the secondary obligor is discharged from any unperformed portion of the secondary obligation as more fully set forth in those sections.\(^{34}\)

Section 41 further codifies the material change defense under Section 37:

If the principal obligor and the obligee agree to a modification, other than an extension of time or a complete or partial release, of the principal obligor’s duties pursuant to the underlying obligation:

(a) any duty of the principal obligor to the secondary obligor of performance or reimbursement is correspondingly modified;

(b) the secondary obligor is discharged from any unperformed duties pursuant to the secondary obligation:

(i) if the modification creates a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed pursuant to the transaction prior to modification.

(ii) in other cases, to the extent that the modification would otherwise cause the secondary obligor a loss; \(^{35}\)

Finally, comments to Section 41 further illuminate the circumstances under which the surety is released from its obligations for a fundamental alteration to the bonded obligation:

d. Discharge. A modification of the underlying obligation can cause the secondary obligor a loss by making the underlying obligation more difficult or expensive to perform, thereby increasing the likelihood that the secondary obligor will be called on to perform the secondary obligation. If the principal obligor is insolvent or otherwise unable to fulfill its duty of reimbursement or restitution, the secondary obligor would suffer a loss to the extent that its unreimbursed cost of performance exceeds that which would have been the case if the modification had not been made. Therefore, the secondary obligation is discharged to the extent of that loss.

e. Fundamental modifications. Under the law of contracts, a substituted contract is a new contract that is accepted by the obligee in satisfaction of the obligor’s existing duty. The substituted contract

\(^{34}\) Restatement (Third) of Suretyship & Guaranty §37 (Am. Law Inst. 1996).

\(^{35}\) Id. at § 41.
discharged the original duty, and breach of the substituted contract by the obligor does not give the obligee a right to enforce the original duty. Thus, if the obligee accepts a substituted contract from the principal obligor, the underlying obligation is satisfied, thereby discharging the secondary obligation. Any default of the principal obligor on the substituted contract does not revive the original underlying obligation or the secondary obligation. A modification of the underlying obligation that imposes risks of the secondary obligor fundamentally different from those present initially is the substantial equivalent of a substituted contract, and similarly discharges the secondary obligation. A series of modifications, no one of which may be fundamental, but which, in the aggregate, have such a fundamental effect, should be treated the same way.36

Such “[m]odification need not be accomplished by changes in the language of the instrument but may be by material departures from its terms in its execution and enforcement.”37 Thus, as a practical matter, there are two broad categories of material alteration, those that involve an actual change to the terms of the bonded contract and those that involve a departure from the terms. The result is the same: when the facts and circumstances indicate that the obligee has created a situation in which the principal's obligations have been fundamentally changed to the prejudice of the surety, the surety has a viable material change defense.

A. Material Alteration by Amendment to the Contract

A material alteration may be effected by an amendment to the contract itself, e.g., an amendment to the contract that significantly increases the size, scope, and/or cost of the contract or creates a major change in the obligations of the principal. As stated by the Court of Appeals for the District of Columbia:

A surety company is not a public utility. It may, for any or no reason, conclude not to furnish its bond with respect to a particular contract. When it has committed itself with respect to one contract, amendments which convert that agreement into a significantly different one should be brought to the attention of the surety so that it may exercise its own business judgment as to whether it wishes to continue its commitment. It is not for the parties to the contract to decide among themselves that their amendments are of no interest to the surety, at least when, as here, those amendments go beyond mere matters of form.38

Changes not within the contemplation of the parties when the contract was made are the pivotal changes to consider in the analysis of a given amendment to the contract. Perhaps the most iconic change of this sort in the construction context would be a change in the nature of the building or a complete change of the type of occupancy, such as from a weekend cabin to a large office building, or the more colloquial “an outhouse to the Taj Mahal.”

36 Id. at §41, cmts. d-e (emphasis added).
37 St. Petersburg Bank & Trust Co. v. Boutin, 445 F.2d 1028, 1031 (5th Cir. 1971).
38 Reliance Ins. Co. v. Colbert, 365 F.2d 530, 534 (D.C. Cir. 1966); United States ex rel Army Athletic Asso. v. Reliance Ins. Co., 799 F.2d 1382, 1386 (9th Cir. 1986)..
In *Success Construction Corporation*, for example, the parties to the underlying construction contract altered the contract to require the contractor to install extensive stone finishes on a construction project. That work was not included in the original bonded contract, and its inclusion increased the $195,000 contract by an additional $350,000, more than doubling the original contract price. The court recognized that the principle of *strictissimi juris* had been somewhat relaxed in terms of minor alterations to the contract but ruled that the inclusion of previously excluded work accompanied by such an increase in the contract price without the surety’s knowledge was a material alteration that substantially increased the surety’s risk and prejudiced the surety.\(^{39}\)

Similarly, the court in *Employer’s Insurance of Wausau v. Construction Management Engineers* determined that when a subcontractor who had originally contracted to perform a portion of the construction work undertook to perform the entire scope of work that the general contractor had originally agreed to perform, nearly tripling the contract amount, the contract was substantially altered.\(^{40}\)

The Ninth Circuit’s decision in *United States ex rel Army Athletic Association v. Reliance Insurance Co.*\(^{41}\) provides an example of an agreed material alteration effected by a change to one part of the amendment to the language of the contract itself that actually reduced the principal’s overall obligation but concomitantly reduced its right to essential funds, thereby prejudicing the surety. That case involved an agreement between the Army-Navy ’83 Foundation (“Foundation”) and the Army Athletic Association and Naval Academy Athletic Association (“Academies”) in which the Foundation agreed to facilitate preparations for the 1983 Army-Navy Football Game. The goal of the parties was to ensure that the Academies would receive similar net revenue for the 1983 game as they had for the 1982 game. As part of the agreement, the Foundation was entitled to revenue from ticket sales and television proceeds but was required to pay a set amount to the Academies from those sources along with concessions proceeds. Moreover, the Foundation agreed to pay for the costs of transporting cadets, midshipmen, and other support personnel to the game. Finally, the Foundation was required to compensate the Academies for the dollar amount of additional expenses the Academies incurred for the 1983 game that exceeded the dollar amount of expenses incurred for the 1982 game.

After the surety issued the bonds based on its understanding that the Foundation was entitled to revenue from the television broadcast, the Foundation and Academies agreed to three modifications of the contract. The first changed the date of the game, which the court did not address and presumably was not at all material.\(^{42}\) The second took away the Foundation’s rights to a portion of the television revenue but also relieved the Foundation from its obligation to guarantee that amount to the Academies, so the court treated the second modification as having no net effect.\(^{43}\) The third modification, upon which the court focused, allowed the Foundation to postpone its obligation to pay the transportation costs, but in exchange required the Foundation to waive its rights to


\(^{41}\) 799 F.2d 1382 (9th Cir. 1986).

\(^{42}\) *Id.* at 1385.

\(^{43}\) *Id.*
ticket revenue and the remainder of the television proceeds.\textsuperscript{44} When the Foundation failed to pay the Academies for the additional expenses as agreed, the Academies filed suit.

Although the surety had issued two separate bonds, and the Foundation had only defaulted on the additional expense obligation, the court nonetheless recognized that the surety had “guaranteed the Foundation’s obligation on the basis of the entire contract, not just a single provision.”\textsuperscript{45} It therefore looked outside the immediate provision of the contract that formed the basis of the expense bond and considered all of the contract provisions, including the third amendment. The court determined that—absent the Foundation’s right to television revenues that would be used to meet the Foundation’s contractual obligations—the surety would likely deem the risk to be too great and therefore decline to write the bonds.\textsuperscript{46} The court concluded that the surety suffered prejudice from that increased risk, of which the surety was not aware and to which it did not consent, that resulted from the modifications.\textsuperscript{47} The court ruled that the surety was exonerated.\textsuperscript{48}

In sum, if the underlying contract is altered such that it is so different in scope, cost, or obligation from the original that it becomes a risk materially different from the one the surety bonded, then those changes may form the basis of a material alteration defense.

B. Material Alteration by Departure from the Contract Terms

The obligee’s deviation from and/or failure to enforce the contract terms may also effect a surety’s discharge. The justification is the same as for discharge for an agreed-upon contract amendment: it creates an unfair change to the bonded risk. The key consideration is, therefore, whether the obligee materially deviated or allowed a deviation from the terms of the bonded contract in such a way that unfairly prejudiced the surety.

An obligee’s failure to strictly adhere to the payment terms of bonded a contract is probably the most typical basis for application of the material alteration defense in terms of a departure from the contract terms. This can happen in many ways. For instance, an obligee may release funds without inspection or testing as required by the contract, or might substantially deviate from an agreed upon schedule of values, resulting in the release of unearned funds. Or the obligee might pay for stored materials without requiring compliance with the conditions precedent in the contract for payment for such material (\textit{e.g.}, payment without verification, payment without requiring the material be on site, payment without requiring the material be placed in a bonded warehouse, etc.). Undoubtedly, one of the reasons that an obligee’s failure to comply with or enforce the payment provision of the bonded contract is often the basis of a material change defense is the obvious harm that typically results from the

\textsuperscript{44} Id. at 1385 – 86.
\textsuperscript{45} Id. at 1386.
\textsuperscript{46} Id.
\textsuperscript{47} Id.
\textsuperscript{48} Id. at 1388.
overpayment.\textsuperscript{49} “Such a procedure diminishes funds that should have been available to the surety in case of default, eliminates the architects’ assurance that payments to the contractor are being used for the job, and undermines the inducement to the contractor to finish the work on schedule in order to be paid.”\textsuperscript{50} That failure to abide by the contract’s terms therefore results in a reduction of funds and incentives that harms the surety and may discharge the surety’s obligation in whole or in part. In this context, the material alteration defense is sometimes synonymously referred to as “the overpayment defense.” While an “overpayment” defense is sometimes spoken of as a separate defense in and of itself, the obligee’s nonadherence to the payment terms or failure to satisfy conditions precedent to payment are simply material alterations that become evident upon the payment that results.

As an example, the obligee general contractor in \textit{Southwood Builders, Inc. v. Peerless Insurance Company} subcontracted with the principal subcontractor to perform drywall work on an office building. One of the subcontract terms was that the contract price of $79,500 was payable as the work progressed and “based upon estimates of the Architect.”\textsuperscript{51} Several months into the job, when it became evident that the principal would not be able to perform its work according to schedule, the obligee proposed a payment arrangement with the principal on the side without notifying the surety. In exchange for the principal’s addition of another drywall crew, the obligee agreed to pay for that crew and materials, bypassing the architect, with the additional costs for crew and materials to be deducted from future progress payments. The obligee paid those costs and even made an additional progress payment to the principal in spite of the fact that the architect had rejected the principal’s claim for payment. By the time the principal finally acknowledged that it could not complete the job, the obligee had paid over $11,000.00 in addition to that approved by the architect. Moreover, $20,000.00 worth of material that the subcontractor had represented to be on site was nowhere to be found.

The court considered the $11,000.00 payment that the obligee had made in addition to the $20,000.00 of missing material and compared that $31,000.00 impact to the original contract price.\textsuperscript{52} The court determined that “[t]he monetary impact of [the obligee’s] deal with [the principal] was substantial” and discharged the surety.\textsuperscript{53} Notably, the court also held that a separate showing of prejudice was unnecessary because the material alteration itself demonstrated sufficient prejudice.\textsuperscript{54}

The vagaries inherent in the construction industry and the realities of a principal’s need for cash flow may drive an obligee’s ill-fated decision to overlook payment terms to keep the project moving. Many a contractor that encounters a tight cash flow, like the principal in \textit{Southwood Builders}, believes it needs only a relatively “minor” cash boost to remedy the problem and continue work, and even with a significant lack of liquidity, the more optimistic contractor needs only to “win this next big bid” that it is certain to clinch. It may be tempting in the face of such contagious sanguinity for the obligee to alleviate

\textsuperscript{51} Id. at 105.
\textsuperscript{52} Id. at 108.
\textsuperscript{53} Id.
\textsuperscript{54} Id. at 107.
performance problems by skirting the payment terms and making an early payment to prop up a contractor, especially when the obligee and principal share a long history and a degree of trust. But as demonstrated in *Southwood Builders*, while motives may be pure on the part of both parties to the underlying contract, deviations from the contract based on those pure motives may still support a material alteration defense.

The Texas Supreme Court’s decision in *Old Colony Insurance Co. v. City of Quitman*\(^{55}\) illustrates another instance of an obligee’s deviation from the contract, this time arising from a failure to require testing.\(^{56}\) There, the bonded contract was for the drilling of a water well for the City of Quitman. The contract required that the contractor drill a test well and have the water tested for iron content. If the iron in the sample was within limits set by the contract, then the contractor would drill the water well and have another sample tested before the water was introduced into the City’s water supply. The contractor was supposed to furnish the results of the final test to the City, but instead the City accepted the drilling company’s representation that the iron content was the same as the test well sample.\(^{57}\) After a delay of some four months from the City’s acceptance of the well, the City discovered that the iron content of the water well was higher than had been represented and filed suit against the drilling company and the surety to recover the full amount paid under the contract.\(^{58}\)

The trial court granted the City’s motion for summary judgment against both the drilling company and the surety for the full amount of the contract. On appeal, the surety argued that it was released from liability because the City failed to obtain the contractually-required test results from the completed well, but the court of appeals affirmed. The Texas Supreme Court reversed, agreeing with the surety and holding that summary judgment for the City was in error.\(^{59}\) The court recognized that had the City required compliance with the contract when it was obligated to do so, the water at that time may have met the requirements, and if it did not, the contractor could have pursued other avenues of compliance with the contract, thereby eliminating any need to look to the surety for performance.\(^{60}\) The court stated the following:

> There is a difference between binding the surety to a guaranty of performance without exception where the other party for whom the work is being done adheres to the contract, and where, as here, it is sought to hold the surety regardless of substantial deviations from the contract by the party for whom the work is being performed.\(^{61}\)

*Old Colony* illustrates a pivotal point—the surety is not a blanket insurer who remains responsible for a given obligation regardless of the obligee’s failure to adhere to and enforce the terms of the bonded contract. Thus, the starting point in evaluating a material alteration defense based on deviation from the contract is the contract terms. Common places to look for potential alterations are, of course, payment provisions and

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\(^{55}\) 352 S.W.2d 452 (Tex. 1961).
\(^{56}\) *Id.* at 455.
\(^{57}\) *Id.* at 453.
\(^{58}\) *Id.*
\(^{59}\) *Id.* at 454.
\(^{60}\) *Id.* at 456.
\(^{61}\) *Id.* at 456.
related conditions precedent. For example, failure to test, inspect, require submittals, or require compliance with conditions precedent to payment may all provide a basis for the defense. The failure to address such issues when they arise can irreparably harm jobsite progress once work is covered up and necessitates a complete rework down the road. In other words, extra care should be taken to fully flesh out the possibilities of damages that may arise, whether easily defined or not.

C. Consent-to-Change Provisions

A typical consent-to-change bond provision might look like the following:

No change, extension of time, alteration, addition, omission, or other modification of the terms of said Contract shall in anywise affect [the surety's] obligation on this Bond, and it does hereby waive notice of any such changes, extensions of time, alterations, additions, omissions, and other modifications.

As noted above, the inclusion of consent-to-change provisions in bonds was an offshoot of the commercial realities that came with the advent of corporate sureties. The underlying commercial transactions that became the subject of bonds did not lend themselves to application of the strict discharge rules in place until the 19th Century. For instance, on construction projects, agreed-upon changes between the obligee and the principal are commonplace and expected. Historically, even the smallest change to a contract, consensual or not, without the surety’s approval, would discharge the surety. The inclusion of a consent-to-change provision in a bond is intended to make clear that the parties need not obtain the surety’s consent to ordinary change orders for minor changes in the work or for extensions of time.

Some mistakenly confuse consent-to-change provisions in a bond as a blanket authorization of alterations of the bonded contract that avoid application of the material alteration defense. That is clearly not the case. Although consent-to-change provisions are sometimes broad on their face, they are not intended to allow for material changes to the bonded contract that “impose[] risks on the [surety] fundamentally different from those present initially,” which operate as a virtual abandonment of the original contract and the substitution of a new one in its place.62 “[C]hanges not fairly within the contemplation of the parties at the time the contract was made, constituting a material departure from the original undertaking, will release a nonconsenting surety from its obligations under its bonds,” regardless of the presence of a consent-to-change provision.63 Agreeing to allow contracting parties to make typical alterations and modifications without consent of the surety does not equate to agreement to allow the parties to disregard the contract terms or make changes that materially alter the surety’s obligations altogether.64

As an example, the meaning of the term “modification,” as interpreted by the Texas Supreme Court, precluded “modification” from meaning “material alteration,” and consent to a “modification” in a consent-to-change provision permitted only “[a] change; an alteration which introduces new elements into the details, or cancels some of them, but leaves the general purpose and effect of the subject-matter intact. . . . The power to modify anything does not imply a power to substitute a thing entirely different, and it does not confer the power to destroy.”65 Interpreting the consent-to-change provision in the bond as consent to “material alterations” would improperly extend the operation of the terms of the provision to include actions implicitly excluded by its plain meaning. Such construction that extends the operation of contract terms is to be avoided, accepting instead the natural and obvious import of the language.66

In considering a construction contract that provided for the owner’s ability to make changes thereto, the Fourth Circuit has held that such provision encompasses:

[C]hanges of a minor character, which do not alter the essential nature of the project covered by the contract, and that it does not bind the surety to the performance of an agreement by the contractor which involves a change so substantial and material as to amount to a departure from the original contract or undertaking of a new and independent project.67

In short, the consent-to-change provision in the bond covers those situations where the contract itself is changed in certain enumerated ways, but the essence of the underlying contract remains the same. Conversely, material alterations are those that operate as an actual or virtual substitution of a new bonded risk. Logically, the parties cannot “change,” “alter,” or “modify” a contract that, for all practical purposes, no longer exists.

III. Extent of Discharge

Once a change is found to be a material alteration causing injury, the next consideration is the extent of the discharge. Broadly speaking, the discharge may be complete or partial—in toto or pro tanto, respectively—depending on the jurisdiction.

Historically, in keeping with the doctrine of strictissimi juris, any alteration of the bonded contract resulted in a complete discharge of the bonded surety. Again, however, with the advent of the compensated surety, the approach to discharge changed to some extent. Courts generally began to require a showing of the surety’s prejudice—whether demonstrated by the surety or presumed as a matter of law given the extent of the material alteration. And some courts began to replace the rule of complete discharge with an approach that measured the extent of the discharge in light of the degree of demonstrated prejudice. Some courts determined that the surety’s discharge should be

67 Maryland Cas. Co. v. City of South Norfolk, 54 F.2d 1032, 1036 (4th Cir. 1932).
limited to the specifically all loss that arises from the impairment of the security.\textsuperscript{68} Some courts found it difficult to measure damages attributable to prejudice to the surety, and over time, “significant differences” arose among and within the states with regard to their respective treatment of the extent of the surety’s discharge in the event of a material alteration to the bonded contract.\textsuperscript{69} As a result, in some jurisdictions, the rule of complete discharge gave way to a rule of partial discharge for compensated sureties.

The rule of complete discharge nonetheless lives on, albeit in a minority of jurisdictions, including Virginia and Texas. The \textit{Old Colony} case discussed above provides a good analysis of the effects of a material deviation by the obligee from the contract terms, and it provides a compelling reason why a complete discharge is actually warranted in cases that may superficially appear to involve material alterations that cause a finite degree of harm. As discussed above, \textit{Old Colony} involved the obligee’s failure to require that the chemical content inspection take place, and the court recognized the extent of the harm that could arise from such failure:

\[F\]rom the standpoint of the surety, there is no way of knowing the chemical content of the water in the finished well at the time it was accepted by respondent, and whether or not that which intervened in the succeeding months before City turned the water into its mains affected the chemical content of the water. It is apparent that had the water been tested at the time the well was finished and before acceptance by City there could have been one of two results, either of which would have obviated the question of City looking to petitioner under the performance bond: the water \textit{at that time} might have equaled the test hole water analysis; or, if not, the contractor might at that time have been able to find water, or to treat the water, so as to meet the contract requirements. . . .\textsuperscript{70}

It is important to note that the court did not focus on the dollar amount of some injury suffered by the surety at the end of the project but rather on the mere possibility that by addressing potential problems earlier in the life cycle of the project, the range of possibilities to remedy the problem would be preserved. After recognizing the various options potentially available, the court noted that if the contractor had exhausted those options and still been unable to meet the contract requirements, the city could have avoided making final payment.\textsuperscript{71} The court therefore determined that the surety suffered injury as a matter of law, and the prejudice extended not just to a finite provision in the agreement but to the entire contract:

Respondent, by its acts, in not requiring compliance with the contract, prevented the happening of either of these possibilities and thereby prejudiced a right of petitioner as surety going to the whole contract. The situation is therefore not one where the contract deviations failed to

\textsuperscript{69} \textit{Nat’l Sur. Corp. v. United States}, 118 F.3d 1542, 1548 (Fed. Cir. 1997).
\textsuperscript{70} \textit{Old Colony Ins. Co.}, 352 S.W.2d at 455-56 (emphasis added).
\textsuperscript{71} \textit{Id.} at 456.
prejudice or damage the surety but is one where there is injury to the surety as a matter of law going to the whole contract obligation.\textsuperscript{72}

The court went on to address the city’s argument that no certificate of acceptance or engineer’s approval would relieve the surety of contractor of its obligation and that the surety was thereby bound by the same obligation.\textsuperscript{73} The court recognized that such an interpretation would obligate the surety regardless of even a substantial deviation from the contract and abrogate all of the surety’s rights.\textsuperscript{74} The correct interpretation was that the contract provisions prevented the contractor from escaping liability for defective work that appeared subsequent to acceptance and final payment, not that the surety was bound regardless of alterations to the contract.\textsuperscript{75}

As illustrated by \textit{Old Colony}, the inability to go back in time to the point where the material alteration occurred, precisely measure the resulting injury, and make the surety whole underscores the reasoning behind complete discharge. The power of and potential damage caused by the passage of time cannot be overstated, especially when a troubled principal is spending both time and resources trying to recover from business setbacks on a failing project. This is a consideration not only for obligees who may be faced with a decision to cut corners or otherwise violate the terms of the bonded contract in a way that makes sense in the moment, but it is also a key point in the surety’s analysis of the injury that it suffered due to the obligee’s departure from the terms of the contract. What sometimes goes unrecognized by courts, particularly those in jurisdictions applying a \textit{pro tanto} approach, is that the failure of an obligee to adhere to and enforce the terms of the bonded contract can result in extreme prejudice to the surety that simply is not readily measureable in dollars and cents.

The rule of \textit{pro tanto} discharge applies in a majority of jurisdictions, including on federal projects. In \textit{pro tanto} jurisdictions, material alteration results in a discharge of the surety to the extent that the material alteration results in prejudice.\textsuperscript{76} The \textit{pro tanto} approach aligns with the treatment of the measure of damages set forth in the Restatement’s description of impairment of collateral:

If the underlying obligation is secured by a security interest in collateral and the obligee impairs the value of that interest, the secondary obligation is discharged to the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the secondary obligor pursuant to its subrogation rights (§§ 27-31) and the value of the secondary obligor’s interest in the collateral.\textsuperscript{77}

\begin{enumerate}
\item \textit{Id.}\textsuperscript{72}
\item \textit{Id.}\textsuperscript{73}
\item \textit{Id.}\textsuperscript{74}
\item \textit{Id.}\textsuperscript{75}
\item \textit{Nat’l Union Indem. Co. v. G.E. Bass & Co.}, 369 F.2d 75, 77 (5th Cir. 1966) (applying Mississippi law) (“Where there has been a material departure from contractual provisions relating to payments and the security of retained funds, a compensated surety is discharged from its obligations on the performance bond to the extent that such unauthorized payments result in prejudice or injury.”) (emphasis added); see also \textit{Nat’l Sur. Corp.}, 118 F.3d at 1548 (explaining that the trend, particularly for compensated commercial sureties, is in the direction of \textit{pro tanto} discharge).
\item \textit{Restatement (Third) of Suretyship & Guaranty} §42 (Am. Law. Inst. 1996).
\end{enumerate}
But even in the pro tonto discharge jurisdictions, the application of a rule of partial discharge is often not absolute depending on whether or not the prejudice can be measured. If the damage or prejudice to the surety resulting from the alteration is quantifiable, jurisdictions will often allow a discharge of the surety’s obligations to the extent of the quantified prejudice, but if the prejudice or increased risk is not quantifiable, the surety may be entitled to a complete discharge.\(^7\)

The pro tonto discharge approach is illustrated in National Surety Corp. v. United States. There, the obligee improperly released retainage to the principal without requiring a critical-path schedule beforehand as required by the contract. The contractor later abandoned the project, leaving the surety to complete performance. The Court of Federal Claims ruled on summary judgment that the surety was entitled to the full amount of money that the obligee should have retained plus interest.\(^7\) The Court of Appeals for the Federal Circuit agreed with the ruling as to liability but disagreed with the measure of damages.\(^8\) It stated that rather than simply releasing the surety to the extent of the improperly paid retainage, the court should consider what the contractor did with the released funds and whether the surety’s injury was thereby reduced.\(^9\) It noted on the other hand that the court should consider the “opposite effects” of the payment, including whether the improper payment of retainage reduced the principal’s incentive to complete the work.\(^9\) The appeals court further cited Sixth Circuit authority\(^9\) that noted the contention by some that a surety should have a total discharge in light of the difficulty of determining the precise extent of prejudice to the surety by the reduction of incentives for the contractor to perform.\(^10\) In other words, the court determined that the focus of the analysis should not be the dollar amount tied to the material alteration itself but rather to a thorough consideration of the effects upon, i.e., the prejudice to, the surety.

Under such an analysis that ties the extent of discharge to the extent of the prejudice suffered by the surety, it stands to reason that the surety may be discharged to an extent greater than or less than the dollar amount traceable directly to the material alteration itself. Practically speaking, though, there is a risk that all involved may gravitate toward those elements of prejudice that are easily measured and quantifiable, such as making the assumption that a change in contract scope only prejudices the surety to the dollar value of the change, or assuming that the amount of an overpayment and resulting dollar value of the reduction in the contract balance represents the totality of the amount of prejudice suffered by the surety. But while the dollar values for the contract change or in the contract balance are often the most easily measured prejudice, focusing only on the readily measurable dollar values (e.g., payments of contract funds) fails to take into account the potentially damaging results of the alteration that do not manifest themselves so clearly, such as delays and lost opportunities.

\(^8\) Nat’l Sur. Corp., 118 F.3d at 1544.
\(^9\) Id. at 1543.
\(^10\) Id. at 1548.
\(^9\) Id.
\(^9\) Hochevar v. Maryland Casualty Co., 114 F.2d 948 (6th Cir. 1940).
The reality of the construction industry is such that a prolonging of the default may indeed be more problematic than ripping off the bandage and declaring the contractor in default, terminating the contractor, and bringing in the surety. The delay in taking necessary corrective measures may be even more detrimental to the surety’s interest in the long term because of the options lost while the contractor is being propped up by the extra-contractual payments. Lost opportunities coupled with the passage of time may be difficult to measure but are nonetheless critical in the analysis of a surety’s liability. For example, delays often arise when cash flow problems lead to under staffing and interruption of the delivery of materials. Efficiencies are lost due to high turnover of key leadership on the jobsite who see the writing on the wall when a job is going south. Opportunities for the surety’s input and assistance are lost as the job limps along toward its inevitable last breath. In other words, once it’s out, you cannot put the toothpaste back in the tube. In short, when approaching the extent of the discharge in a pro tanto jurisdiction, the surety should not lose sight of these effects outside early release of contract funds. And, if they cannot be quantified, the surety may have a basis to argue for a complete discharge even in pro tanto jurisdictions.

IV.
Conclusion

The modern, sophisticated surety has responded to the changing landscape of commercial transactions and is able to withstand a degree of changing risk. It has not yet, however, attained clairvoyance and cannot anticipate major changes to its obligation. The material change doctrine reflects that fact. Although the rule of strictissimi juris is no longer applied in all circumstances, when the changes to a bonded contract are fundamental and spring from the conduct or demands of the obligee, the surety may not be bound. Of course, it is always important for the surety to understand the underlying contract’s terms and obligations prior to issuing a bond. It is also critical when analyzing the surety’s liability upon default to carefully consider whether those terms were followed and enforced during performance of the work so that the surety’s obligations and risk were not unfairly expanded.