Surety Discharge Due To Changes
(A Somewhat Mythical Defense)

By J. Kevin Bridston
Holland & Hart LLP

On many private construction projects, and virtually every public construction project, the general contractor is required to obtain a surety bond, most typically a payment and performance bond. *See*, for example, C.R.S. § 38-26-105. The purpose of such bonds is to protect the owner if the general contractor does not complete the project or fails to pay its subcontractors and materialmen, and to protect subcontractors and materialmen against the risk of non-payment by the general contractor.

When a project goes bad – for example, because the general contractor goes into bankruptcy - the remaining project participants typically make demand on the surety to complete performance and/or payments on the project. Sometimes bonding companies recognize their responsibility and fulfill their performance and/or payment obligations. It is not unusual, however, for a surety to resist making payments while attempting to extract some kind of discount.

Often sureties rely on a variety of defenses that they claim discharge their obligations under the bonds. On a superficial level these defenses sound viable, and for lawyers they may harken back to concepts learned in law school. On closer examination, however, most of these defenses, particularly those based on changes under a construction contract, will not apply in favor of a commercial surety.

Sureties Are Not "Favorites of the Law"

Claimants and counsel who deal with sureties will often hear the refrain from sureties that "sureties are favorites of the law."[1] That concept can indeed be found in some of the older cases, but it largely developed before the advent of commercial sureties. It remains true that uncompensated sureties are treated as favorites of the law,

[1] Sureties also often argue that surety is not insurance, and while that is true in some ways, it is untrue in others. Surety is really a form of guarantee rather than insurance, and a surety has the right of indemnification against its principal (typically the contractor). That fact has no bearing on sureties' obligations to the beneficiaries of a bond. As to the beneficiaries (or obligees, as they are often called), surety is very much akin to insurance. In fact, sureties generally are regulated by the state insurance commission.

and there are many events that may result in an uncompensated surety's obligation being discharged. The general rule for an uncompensated surety is that any change in the underlying contract without the surety's consent will discharge the surety obligation.

But those rules have no application in the context of compensated sureties.

> The doctrine that a surety is a favorite of the law . . . does not apply where the bond or undertaking is executed upon a consideration by a corporation organized to make such bonds or undertakings for profit. While such corporations may call themselves "surety companies," their business is in all essential particulars that of insurers. Their contracts are usually in the terms prescribed by themselves, and should be construed most strongly in favor of the obligee.

Federal Sur. Co. v. White, 295 P. 281, 290 (Colo. 1930) (quoting *Empire State Sur. Co. v. Lindenmeier,* 131 P. 437, 440 (1913)). *See also Transamerica Premier Ins. Co. v. Brighton Sch. Dist. 27J,* 940 P.2d 348, 351-52 (Colo. 1997). If surety bonds are to be construed in favor of the obligee, then they cannot and in fact are not released simply because of changes in the underlying work.

Bonds Are Interpreted As Incorporating the Underlying Contract, Including Change Clauses

Of course, virtually all construction contracts contemplate that changes will be made. Some bonds expressly provide that the surety will be obligated on changes regardless of whether notices provided to the surety. More often than not, though, the bond says something like the following:

> Know all men by these presents, that we [prime contractor], as principal, and [bonding company], as surety are held and firmly bound unto [owner], in the penal sum of [$_______________], in good and lawful money of the United States of America, for the payment whereof, well and truly to be made, we bind ourselves, jointly and severally, firmly by these presents.
>
> The condition of the obligation is that the principal and [owner] have entered into a certain contract dated _____________ to [brief description of the project].
>
> Now, therefore, if the said principal, his sub-contractor or sub-contractors, and each and all of them, shall duly pay for all labor, materials, and other supplies used or consumed in the performance of the work contracted to be done or any part thereof, and if the said principal shall also fully indemnify and save harmless [owner], from any and all damages or loss which [owner] may or shall suffer by reason of the default of the principal or anyone acting for him as sub-contractor in

> connection with such payments, these presents shall become void, otherwise to be and remain in full force and effect.

That language can hardly be claimed as a model of clarity. In fact, it is virtually undecipherable. Nevertheless, courts faced with similar language have uniformly held that the bond and contract must be read together to determine the liability of the surety, with the basic principle being that the bond using such language incorporates the terms of the contract. *See, e.g., A.S. Ripley Bldg. Co. v. Coors,* 84 P. 817, 818 (Colo. 1906); *Federal Surety Co. v. White,* 296 P.281, 290 (Colo. 1930). *Cf. CPS Distributors, Inc. v. Federal Ins. Co.,* 685 P.2d 783, 785 (holding that public works statutes define the extent of an obligation of a surety on a public works bond).

Given that most construction contracts include change provisions, most bonds should be interpreted as also including such change provisions. Where the underlying contract expressly provides for changes, the surety should have no argument that changes in the work somehow discharge the surety's obligations. But that does not keep sureties from trying.

<u>Changes to the Underlying Contract Do Not Discharge a Surety Unless the Surety Can Demonstrate Prejudice</u>

Again, in response to claims made on bonds, sureties often claim that there are or may be discharge issues as a result of changes in the underlying contract. Typically they do not simply deny a claim on this basis (and in fact they should not, because the doctrine of bad faith applies to sureties much as it does to insurers, *see Transamerica Premier Ins. Co. v. Brighton School Dist.,* 273, 940 P.2d 348 (Colo. 1997)). Instead, they may vaguely hint at possible discharge issues that need to be investigated. After some period of investigation a surety may complain that changes were made to the underlying contract and they were not notified. They may argue that there is a good deal of case law to the effect that sureties are discharged if the underlying contract is changed without the surety's consent.

In fact, there is a good deal of case law that says that a surety is discharged if the underlying contract is changed without the surety's consent, but that law applies only to non-compensated sureties, which truly are favorites of the law. With respect to compensated sureties, the general rule is that changes to the underlying contract will only discharge a surety if the surety can demonstrate some type of prejudice. Even then, typically the discharge is limited to the amount of prejudice.

Sureties' efforts to avoid their obligations under a bond based on changes in the underlying contract have been almost uniformly rejected in Colorado:

> [A surety] having, for a compensation, become surety upon the bond executed by the defendant as surety for the performance of the contract, it could not escape liability by reasons of alterations or deviations from the exact terms of said contract or of said bond, where no damages are shown

> to have resulted to said surety by reason of such alterations or deviations; . . . such a bond was in the nature of an insurance policy, and is not to be construed as strictly as a bond executed by a non-compensated surety who signed merely for an accommodation of the principal, etc.

National Surety Co. v. Queen City Land & Mort. Co., 164 P. 722, 724 (Colo. 1917).

This theme is repeated again and again in Colorado law. *See, e.g., National Union Fire Ins. Co. v. Denver Brick & Pipe Co.,* 427 P.2d 861, 867 (Colo. 1967) ("the general rule is that in order to relieve a compensated surety from liability where there has been an alteration or deviation from the terms of a contract, the surety must be prejudiced thereby"); *Federal Surety Co. v. White,* 295 P.281, 290 ("the modern day surety company must show some injury done before they can be absolved from the contracts which they claim are to execute").

On the other hand, a change in the contract that is so material as to constitute a cardinal change probably will discharge a surety. In other words, a surety "cannot be bound as surety on a contract radically different from that which it executed." *Empson v. Aetna Cas. & Sur.,* 206 P. 378, 379 (Colo. 1922).[2]

Sureties also sometimes argue that premature payment of a contractor or failure to withhold contractually permitted retainage will discharge their liability on the bond. Again, however, this defense will not work unless the surety can demonstrate that it has somehow been prejudiced:

> So to release a surety it has been held that an overpayment must undoubtedly be of such an amount, relative to the whole contract, or to that part of it left undone, that the Court can say as a matter of law, or a jury as a matter of fact, that a material incentive to the completion of the contract has been done away with to the detriment of the surety.
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> * * *
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> A premature payment will not discharge the surety where it is made with his knowledge and acquiescence, or by his request.

[2] Exactly what constitutes a cardinal change is somewhat subjective, and very fact specific. In general, where the number or scope of changes far exceeds what the parties reasonably could have anticipated at the time of contracting, there is a cardinal change, or abandonment of the contract. Aaron P. Silberman, *Beyond Changes: Abandonment and Cardinal Change*, The Construction Lawyer, Fall 2002, at 5. *See also H.T.C. Corp. v. Olds*, 486 P.2d 463 (Colo. App. 1971) (not selected for official publication) (holding that over 40 major changes on saloon supported finding of abandonment).

Federal Surety Co. v. White, 295 P.281, 289 (Colo. 1930).

The bottom line is that a surety claiming defenses to a bond claim bears the burden of proving its defenses. That burden is generally a heavy burden, as the surety must demonstrate some prejudice from the change. Given that virtually all construction contracts contemplate changes, it should only be in rare cases that a surety can establish sufficient prejudice to obtain discharge in whole or part under the bond.