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CONTRACT LAW

SUMMARY

UNITED STATES v. RELIANCE INSURANCE CO.: NINTH CIRCUIT RECOGNIZES A NEED TO PROTECT SURETIES

I. INTRODUCTION

In *United States v. Reliance Insurance Co.*,¹ the Ninth Circuit held that a material modification of an underlying contract relieved a surety of its liability under a bond.² The holding demonstrated the court's recognition of the need to protect sureties against prejudicial modifications.

II. FACTS

In February of 1983, the Army-Navy '83 Foundation (Foundation) was formed to facilitate preparations for the 1983 Army-Navy football game.³ Foundation thereafter, entered into a contract with the Army Athletic Association and the Naval Academy Athletic Association (collectively the Academies).⁴ The contract provided that Foundation would receive all revenues generated from ticket sales and broadcasting rights, and in return Foundation promised to pay each Academy their share of

1. 799 F.2d 1382 (9th Cir. 1986) (per Jameson, D.J., District of Montana, sitting by designation; the other panel members were Tang, J., and Brunetti J.).

2. *Id.* at 1387.

3. *Id.* at 1383.

4. *Id.*

revenues,⁵ provide funds for transportation and housing,⁶ and compensate the Academies up to \$200,000 for any costs in excess of those expenses incurred by the Academies in the 1982 Army-Navy game.⁷ Finally, to secure its obligations the contract required Foundation to obtain two bonds, one of which secured the \$200,000, and was the subject of the lawsuit.⁸

Foundation thereafter, entered into a contract with Reliance Insurance Company (Reliance) whereby Reliance agreed to issue the bonds.⁹ Foundation assured Reliance that Foundation was entitled to the television proceeds from the game.¹⁰ However, subsequent to the issuance of the bonds, the Academies and Foundation, without the knowledge or consent of Reliance, agreed to three modifications.¹¹ The first modification merely changed the date of the game. The second alteration provided that the Academies' share of the television proceeds, \$1,100,000, would be paid directly to the Army Athletic Association, thereby relieving Foundation of its \$1,100,000 obligation to the Academies.¹² Under the third modification, the Academies agreed to initially pay for transportation, and in return Foundation waived its right to any remaining television or ticket revenues.¹³

Following the modifications, the Academies incurred expenses that were in excess of the costs of the 1982 Army-Navy game. When the Academies demanded that Foundation comply with their agreement and pay \$200,000 to cover the additional expenses, Foundation refused to pay.¹⁴ Thereafter, the United States, on behalf of the Academies brought an action against Re-

5. *Id.* Each Academy was promised \$875,000—\$550,000 from television revenues and \$325,000 from ticket sales and concession proceeds. *Id.*

6. *Id.* The contract required Foundation to provide money to transport the cadets, midshipmen, and support personnel to Pasadena, California, where the game was played. It also required Foundation to provide for housing and meals. *Id.*

7. *Id.*

8. *Id.* at 1383-84. The other bond guaranteed the \$650,000 for ticket and concession revenues. It was released by the Academies when they received their money. *Id.*

9. *Id.* at 1384.

10. *Id.* The television proceeds amounted to \$1,450,000. *Id.* Foundation also assured Reliance that it would assign the television proceeds to Reliance as collateral for the bonds. However, the assignment was never made. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.* Though the facts do not state why Foundation refused to pay, it appears that Foundation had no funds to pay the Academies as a result of the modifications. *Id.*

liance to recover on the bond that guaranteed that amount.¹⁵ Both sides moved for summary judgment.¹⁶ The district court granted Reliance's motion, holding there were undisputed facts supporting the conclusion that the bond was exonerated as a result of material modifications of the underlying contract.¹⁷ Plaintiffs appealed to the Ninth Circuit Court of Appeals.

III. THE COURTS ANALYSIS

The primary issue addressed by the Ninth Circuit in *United States v. Reliance Insurance Co.*¹⁸ was whether the modifications of the bonded contract exonerated Reliance of liability.¹⁹ Generally, a surety will be discharged when the bonded contract is materially changed, without the surety's knowledge or consent, causing damage or prejudice to the surety.²⁰ Cal. Civ. Code § 2819 provides that a surety is discharged if the creditor, without the consent of the surety alters the original obligations, rights, or remedies of the parties.²¹ In *Reliance v. Colbert*,²² the Court of Appeals for the District of Columbia stated that any changes to the underlying contract should be brought to the attention of the surety so it may decide whether it wishes to continue its commitment.²³

Reliance argued the modifications resulted in a net loss to Foundation,²⁴ while the Academies claimed the net effect was a benefit to Foundation.²⁵ The court concluded that neither party was entirely correct. The first and second modification had no effect. The first simply changed the date of the game, and in the

15. *Id.*

16. *Id.* at 1383.

17. *Id.*

18. 799 F.2d 1382.

19. *Id.* at 1385. The Ninth Circuit decided to look to state substantive law for guidance, since there was no clear body of federal law on the subject of sureties. *Id.*

20. See *Argonaut Insurance Co. v. Town of Cloverdale, Indiana*, 699 F.2d 417 (7th Cir. 1983) (surety is discharged if contract is altered without the surety's consent).

21. Cal. Civ. Code § 2819 provides in part, "A surety is exonerated . . . if by any act of the creditor, without the consent of the surety the original obligation of the principal is altered in any respect, or the remedies or rights of the creditor against the principal, in respect thereto, in anyway impaired or suspended."

22. 365 F.2d 530 (D.C.Cir.1966).

23. *Id.* at 534.

24. *Reliance Insurance Co.*, 799 F.2d at 1385.

25. *Id.*

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second, Foundation gave up its right to the \$1,100,000 in ticket revenues, but it was also relieved of its obligation to guarantee that amount.²⁶ However, the third modification had a substantial effect to the detriment of Foundation.²⁷ The language of the modification indicated that though Foundation was no longer entitled to any television revenues, it was still obligated to pay for the transportation and housing.²⁸ The third modification merely shifted the immediate burden of paying for transportation to the Academies, but Foundation was ultimately responsible. In return, Foundation relinquished its sole remaining benefit under the contract, the right to receive the excess television revenues.²⁹ The court found that if Reliance knew that Foundation was not entitled to the television proceeds, it was highly unlikely that Reliance would have issued the bonds since the venture would have been too risky.³⁰ Under the original contract, Foundation would have received money from the television revenues to pay its obligations. Accordingly, the court concluded that the third modification clearly prejudiced Reliance.³¹

The Academies pursued several defenses, all of them unsuccessful. First, the Academies argued that Reliance was estopped from raising the defense of modification because it was based on a claim for television proceeds through an assignment that Foundation promised Reliance, but never made.³² The court explained that the Academies mischaracterized Reliance's defense.³³ Reliance's defense was that the modifications materially altered the underlying contract which accordingly exonerated Reliance from liability. It had nothing to do with the assignment.³⁴ However, the court noted that had Reliance based its defense on the promised assignment, it would have been estopped because it was based on a secret agreement.³⁵

26. *Id.*

27. *Id.* at 1386.

28. *Id.* at 1385-86.

29. *Id.* at 1386.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.* See *Busse v. Pacific Employees Insurance Co.*, 43 Cal. App. 3d 558, 117 Cal. Rptr. 718 (1974).

Secondly, the Academies claimed that Reliance had waived or ratified the modifications of the bonded contract.³⁶ In *Mardirosian v. Lincoln National Life Insurance Co.*,³⁷ the Ninth Circuit stated that a finding of waiver requires a known right, and an intent to relinquish that right.³⁸ Judge Jameson concluded there was insufficient evidence to establish Reliance's knowledge of the modifications,³⁹ or to establish Reliance's consent, or its intent to waive its rights.⁴⁰

IV. CONCLUSION

The Ninth Circuit held that material modifications, at least one of which was prejudicial to Reliance, released Reliance from its obligation under the bond. The decision demonstrated that the Ninth Circuit is reluctant to hold a surety liable on a bond where modifications are made without its consent. Thus, the Ninth Circuit joined with other circuits in recognizing the rights of sureties and the need to protect them against prejudicial alterations.

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36. *Reliance Insurance Co.*, 799 F.2d at 1382.

37. 739 F.2d 474 (9th Cir. 1984).

38. *Id.* at 477.

39. *Reliance Insurance Co.*, 799 F.2d at 1387.

40. *Id.* The Academies' final argument was that the district court deprived them of sufficient opportunity for discovery, by denying their request for further discovery. *Id.* In *Foster v. Arcata Associates*, 772 F.2d 1453 (9th Cir. 1985), the Ninth Circuit held that a district court has wide latitude in permitting discovery, and its ruling will not be overturned unless it clearly abuses its discretion. *Arcata*, 772 F.2d at 1467. Judge Jameson concluded that the Academies had ample opportunity for discovery during the six months after Reliance's answer, and during the four months after providing for discovery. *Reliance Insurance Co.*, 799 F.2d at 1388. Under the circumstances, the Ninth Circuit held that the district court did not abuse its discretion by denying further discovery. *Reliance Insurance Co.*, 799 F.2d at 1388.

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