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THE LAW OF CONSTRUCTION BONDS IN ARKANSAS: A REVIEW

David G. Paul*

In 1929, J.S. Waterman, the dean of the Arkansas School of Law, published an article in the first edition of the Arkansas Law Bulletin. Entitled "Construction Surety Bonds in Arkansas," the article traced the law governing construction bonds in Arkansas. Since the publication of that article, the construction industry in Arkansas has flourished, and the law governing the construction industry has changed and expanded.

Because of their precarious nature, construction contracts have naturally fostered much litigation over their performance. Initial underbidding by the contractor, unforeseen problems with the construction, and other difficulties often result in delay in completion, faulty construction, or outright default by the contractor. The owner, the contractor, and the lender involved in the project may try to resolve any dispute; however, the addition of the claims of subcontractors and materialmen often forecloses any possibility of successfully completing the project.

One possible solution is for the contractor to provide surety bonds to insure its performance of the contract. Essentially contracts, surety bonds are peculiar in that their terms and obligations are governed by statutes and common law which are unique to surety bonds. This article will explore those statutes and precedents in Arkansas which affect construction surety bonds.

I. The Surety Bond

Broadly defined, suretyship is a contractual relationship whereby one entity answers for the obligations of another. For the purposes of this article, however, the definition needs refining. Often described as a


1. Waterman, Construction Surety Bonds in Arkansas, 1 Univ. of Ark. Law School Bull. 59 (1930).

tripartite relationship, a surety bond is a three-way contract between the surety, the principal, and the obligee that secures the performance of the obligations of the principal under a separate contract by obligating the surety to pay a penal sum upon the principal's default. Construction surety bonds were created as a means of protecting those involved with the construction of public improvements. Recognizing the vulnerability of subcontractors in light of court decisions which prohibited liens against public improvements, governmental entities began to require the posting of a bond to secure payments to a subcontractor. Thereafter, private contractors utilized this practice and expanded the protection into a method of securing the performance of the construction contract as well as the payment to subcontractors, laborers, and materialmen. Even so, the Arkansas Supreme Court has pointed out that a contract of ordinary suretyship is not the equivalent of an indemnity agreement, and the court has recognized that the obligations of the surety are limited to those of the principal under the contract between the principal and the obligee.

The most common types of bonds used in the construction industry are the bid bond, the performance bond, and the payment bond. The bid bond is a surety bond which insures that the contractor will enter into a contract by paying the penal sum or the owner's actual damages if the contractor fails to enter into the contract or fails to post the required performance or payment bonds. Insuring that the contractor will complete his obligation under the construction contract, performance bonds obligate the surety to complete the contract or pay damages

5. Where the contract takes the form of ordinary suretyship, "the agreement of the surety is that he will do the thing which the principal has undertaken," whereas, "in indemnity contracts the engagement is to make good and sure another from loss upon some obligation which he has incurred, or is about to incur, to a third person, and is not as in guaranty and suretyship a promise to one whom another is answerable." Fausett Builders, Inc. v. Globe Indem. Co., 220 Ark. 301, 305, 247 S.W.2d 469, 471 (1952) (court's emphasis) (quoting Hall v. Equitable Sur. Co., 126 Ark. 535, 539-40, 191 S.W. 32, 34 (1917)). The court held that the surety was not liable for attorney fees incurred by owner since such an obligation was not a part of the construction contract.
6. Petro, supra note 3, at 509.
CONSTRUCTION BONDS

up to the penal sum of the bond upon the contractor’s default.\(^8\) A payment bond obligates the surety to pay subcontractors, materialmen, and laborers for material and services furnished in performance of the construction contract.\(^9\) Again, the limit of the surety’s liability is the penal sum stated in the bond.

Generally, the surety’s liability is governed by the terms of the bond and the construction contract. Since the liability of the surety is predicated upon the obligations of the principal under the contract, the surety bond and the contract are construed together as one instrument.\(^10\) The liability of the surety will not extend beyond that of the principal,\(^11\) and any defense of the principal to the main contract will normally be available to the surety.\(^12\) Nevertheless, the Arkansas Supreme Court has held that a surety contract is essentially one of insurance, and its interpretation should be governed by the laws of insurance.\(^13\) Also, the court has held that it is to be construed most strongly against a commercial surety.\(^14\)

II. Discharge

Aside from the defenses to the main contract which the surety may assert,\(^16\) the surety may contend that its obligations under the bond have been discharged by the actions of the obligee. A primary defense of the surety, discharge will be pleaded if any action of the obligee has exonerated the surety of liability. Actions such as altera-

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\(^8\) Petro, supra note 3, at 510. In Employers’ Liab. Assurance Corp. v. A.W. Johnson Co., 234 Ark. 806, 354 S.W.2d 733 (1962), the court further refined the term “performance bond” by distinguishing between it and an indemnity bond. Therein, a supplier of materials sued the surety on a bond which indemnified the owner “against loss or damage directly arising by reason of the failure of the Principal faithfully to perform the contract.” Id. at 809, 354 S.W.2d at 734. Citing Pine Bluff Lodge v. Sanders, 86 Ark. 291, 111 S.W. 255 (1908), the court held that an indemnity bond as in that case provided protection only to the obligee and did not allow any causes of action by other third parties, such as materialmen. The court further stated that although the terms of the construction contract were incorporated by reference into the surety bond the bond did guarantee performance of the contract. It was a private bond which did not extend beyond its terms. See also Annotation, Right of Person Furnishing Material or Labor to Maintain Action on Contractor’s Bond to Owner or Public Body, or on Owner’s Bond to Mortgagee, 77 A.L.R. 21 (1932).

\(^9\) Petro, supra note 3, at 511.


\(^12\) Petro, supra note 3, at 516.


\(^14\) American Bonding Co. v. Board of Street Improvement District No. 82, 187 Ark. 300, 59 S.W.2d 605 (1933); Consol. Indem. & Ins. Co. v. State, 184 Ark. 581, 43 S.W.2d 240 (1931).

\(^15\) See generally, A. Stearns, supra note 2.
tions in the principal contract, extensions of time to complete the project, or release of the principal, discharge the surety from his obligation if the surety has not consented to such actions. Consent will not normally be implied by the surety's mere knowledge or acquiescence but must be shown by some affirmative action of the surety.

A major source of contention in construction litigation has been whether the original contract under which the surety is liable has been altered by the obligee and the principal. This type of discharge is based on the theory that the surety is entitled to rely upon the terms of the original contract, and any alteration in the contract likewise alters his obligation, thereby releasing the surety from liability. Nevertheless, the courts have limited this theory to "material" alterations in the contract since the right to make immaterial changes is implied in all building contracts.

The test of materiality, as applied by the Arkansas Supreme Court, is whether the alterations place the surety in a position different from what it promised to guarantee. In *Hinton v. Stanton*, the owner and a contractor entered into a contract to build a house for $3,165. Later, the contract was altered to provide for a porte cochere for an additional $158.50. After the contractor defaulted, the owner sued the surety for $1,591.63, the sum required to complete the contract in excess of the original contract. Defending on the basis of material alteration, the surety contended that the additional work released the surety from its obligation. The question that concerned the court was whether the additional work was a material change in the construction contract.

18. A. Stearns, supra note 2, § 6.2, at 107-08. See also O'Neal v. Kelley, 65 Ark. 550, 47 S.W. 409 (1898).
19. Southwestern Sur. Ins. Co. v. Terry, 122 Ark. 522, 184 S.W. 54 (1916); Hinton v. Stanton, 112 Ark. 207, 165 S.W. 299 (1914); O'Neal v. Kelley, 65 Ark. 550, 47 S.W. 409 (1898); A. Stearns, supra note 2, § 6.3, at 109. See Carroll-Boone Water District v. M & P Equipment Co., 280 Ark. 560, 661 S.W.2d 345 (1983). The court has also held that the surety is not discharged where the changes were allowed by the contract even if the changes were material. Kerby v. Road Improvement Dist., 159 Ark. 21, 251 S.W. 356 (1923). See also Altman v. Sproles, 161 Ark. 128, 255 S.W. 573 (1923).
20. As noted in Hinton v. Stanton, it is contemplated in all building contracts that small and immaterial changes will be suggested, and will become necessary in the progress of the construction of a building, and this fact is necessarily known to one who becomes surety upon a contractor's bond, and if the changes made are slight and immaterial, the surety is not released. Hinton v. Stanton, 112 Ark. 207, 211, 165 S.W. 299, 300 (1914). See also Eureka Stone Co. v. First Christian Church, 86 Ark. 212, 110 S.W. 1042 (1908) (changes which are not material or are authorized by the terms of the contract do not discharge the surety's obligation).
21. 112 Ark. 207, 165 S.W. 299 (1914).
The *porte cochere* was not a part of the plan covered by the bond, and no liability could have arisen against the surety out of its construction. However, if its construction involved some change in the building contract, which a jury should find to be of a material nature, such change would invalidate the bond, unless the consent of the surety was secured. But if the *porte cochere* could be and was attached to the building, without involving any material change in the plan of the building, then the fact that it was constructed would not render the bond invalid; and under the circumstances of this case, the test of materiality of the change is this: Could the owner have made a separate contract for the *porte cochere* and could that contract have been performed without materially changing the contract which [the contractor] had made, and upon which appellee was surety? If this could have been done, then the contract for the *porte cochere* is an additional contract and not a change in the original contract.22

This test was later repeated by the court.23

Concerned with the failure of the contractor to obtain builder's risk insurance as required by the construction contract, the court in *Carroll-Boone Water District v. M & P Equipment Co.*,24 again emphasized the question of whether the surety's position had been altered. The court characterized the problem as a difference between a material alteration and breach of contract.

In determining whether an alteration is material the courts look to see whether the surety has been placed in a position different from that which it promised to guarantee. The alteration is not material unless the surety is placed in the position of doing more than the undertaking contained in the performance bond.25

However, in this case the failure to obtain the builder's risk policy was only a breach of contract and not a material alteration. As such, the surety was not released from its obligation and the owner was entitled to recover on the bond.

Closely related to discharge by alteration of the contract, the

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22. *Id.* at 212-13, 165 S.W. at 300-01.
23. In *Southwestern Sur. Ins. Co. v. Terry*, 122 Ark. 522, 184 S.W. 54 (1916), the surety appealed from a judgment in favor of the owners arising out of the construction of a six-story building. Repeating the test of materiality set forth in *Hinton v. Stanton*, the court stated that the evidence demonstrated that the changes could not be constructed independently of the main contract but necessarily involved material alterations in the original contract. Since the surety had not consented to these material alterations, the surety was discharged from its obligation under the bond. Therefore, the court reversed and dismissed.
25. *Id.* at 569, 661 S.W.2d at 350 (citations omitted).
owner's failure to abide by the terms of the construction contact may also result in the discharge of the surety's obligation. Since the construction contract's terms serve as the basis of the surety's obligation, the courts have required the owner to strictly follow those terms or to risk forfeiting the bond's protection. This issue has most frequently arisen when the owner has failed to retain a percentage of the contract price as security against the contractor's default. The court has refused, however, to allow a complete discharge when the deviation from the contract terms resulted in little or no harm to the surety.

One question which has not been definitely answered by the Arkansas courts is whether the premature progress payments to the contractor by the owner will operate as a complete or pro tanto discharge of the surety's obligations. The Arkansas cases on this point hold both ways without reconciling the conflict. The modern rule would discharge the surety only to the extent of the loss or impairment of his security, and one federal court has followed the pro tanto rule in deciding an Arkansas case.

Discharge of the surety can also be accomplished by releasing the

27. Eureka Stone Co. v. First Christian Church, 86 Ark. 212, 110 S.W. 1042 (1908); Lawhon v. Toors, 73 Ark. 473, 84 S.W. 636 (1905); Marree v. Ingle, 69 Ark. 126, 61 S.W. 369 (1901).
28. In Roland v. Lindsey, 104 Ark. 49, 146 S.W. 115 (1912), the sureties contended that the failure of the owner to obtain fire insurance as required by the contract discharged their obligation. The court disagreed noting that no loss by fire had occurred during the progress of the building. "As the bondsmen sustained no injury by reason of the breach of the contract in regard to insurance, they are not entitled to be relieved from liability for breaches of the contract on the part of the principal." Id. at 57, 146 S.W. at 118.
29. The surety in Marree v. Ingle, 69 Ark. 126, 61 S.W. 369 (1901), claimed a complete discharge because of the failure of the owner to retain a percentage of the contract price. The final installment due the contractor was $333.34 out of which the owner deducted several bills which he had paid. The balance of $192.89 was then paid to the contractor one day earlier than required by the contract. When sued by the owner to discharge a lien by a materialman for $449.75, the sureties claimed that the premature payment worked a complete discharge of their obligation. The court held, however, that the sureties were discharged only of the extent of their injuries. "[W]hen by the act of the creditor the surety has been deprived of the benefit of a fund for the payment of a debt, and the contract by which the surety is bound is not changed, he is only discharged to the extent that he is injured as in such cases." Id. at 129, 61 S.W. at 370-71.
However, in the later cases of Lawhon v. Toors, 73 Ark. 473, 84 S.W. 636 (1905) and National Sur. Co. v. Long, 79 Ark. 523, 96 S.W. 745 (1906), the court held that premature payments to the contractor operated as a complete discharge of the surety. Neither of those cases distinguished the holding of Marree v. Ingle, supra.
30. A. STEARNS, supra note 2, § 6.8, at 124 and cases cited therein. See also 72 C.J.S. Principal and Surety § 206 (1951).
contractor without the permission of the surety. The surety's obligation, being merely ancillary to the main contract, is discharged if the contractor is released from liability by the owner. In Union Indemnity Co. v. Benton County Lumber Co., for example, a surety company issued two surety bonds covering separate paving districts projects of the contractor. After completion of one of the projects, a materialman filed suit against the paving district, the contractors, and the surety to recover monies owed to it by the contractor. In an effort to settle the suit, all of the parties except the surety met to negotiate a settlement, and during this negotiation, an agent of the surety telephoned the attorney for the district and stated that before the surety would do anything further the amounts due the claimants would have to be settled and the suit dismissed with prejudice. Thereafter, a settlement was concluded with the materialman and the suit was dismissed. After the second project was concluded, the materialman once again found the contractor owing money on its account, and the materialman filed suit against the district, the contractor, and the surety asking, among other relief, that the surety be held liable on its bond on the first project to pay for the note it received in settlement of the first suit. The trial court held the surety liable on its bond, but the Arkansas Supreme Court reversed. Noting that the settlement had been negotiated and concluded without active participation by the surety, the court held that the surety's obligation was erased once the contractor's obligation was likewise erased by the settlement. Therefore, the surety was no longer liable on the first bond.

III. Standing

Another possible defense of the surety is that the claimant lacks standing to enforce the surety's obligation. For the most part, the surety has based this defense upon the contention that the claimant must sue through the contractor since the liability of the surety is pred-

33. 179 Ark. 752, 18 S.W.2d 327 (1929).
34. Id. at 754, 18 S.W.2d at 328.
35. In this case the principals have made a settlement by which the debt for which the surety was liable was extinguished and another and different obligation created, to suit their convenience, and the surety, appellant not having consented thereto, was discharged. And consent will not be implied by mere knowledge of and acquiescence in the terms of the settlement, but there must be some affirmative action by the party to be bound.

Id. at 761, 18 S.W.2d at 330 (citations omitted).
icated upon the liability of the contractor. At least in the area of public statutory bonds, the Arkansas Supreme Court has rejected this contention by construing the terms of such bonds liberally. Since statutes giving materialmen and laborers liens for their work do not apply to public projects, the court has reasoned that the bonds provide the only available protection to cover the default of the contractor. Only by construing the bonds liberally can claimants receive adequate protection. One such case was National Surety Corp. v. Ideal Lumber Co. After a materialman sued the surety to recover for the sale of materials and tools to the contractor, the surety argued that the contractor's liability must be established before the materialman could obtain a judgment against the surety. The court held otherwise. "We have held that laborers and materialmen may, in cases involving public improvements, sue the surety on the bond of the contractor without making the contractor a party." 4

On the other hand, failure of a contractor to be properly licensed can bar the recovery of the contractor from the surety. As required by section 71-713 of the Arkansas Statutes Annotated, any contractor entering into a construction contract wherein the cost equals or exceeds $20,000 must be licensed by the State Licensing Board for Contractors; otherwise, the contractor is barred from bringing any action to enforce any provision of the contract. The Arkansas Supreme Court has re-

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38. Id. at 454, 42 S.W.2d at 767-68. Also noted in Aetna Casualty & Sur. Co. v. Henslee, 163 Ark. 492, 260 S.W. 414 (1924), was the dual purpose of statutory bonds. The bond sued on was given for two purposes. In the first place, it was given to secure to the commissioners of the district the faithful performance of the contract of the principal contractor with the district; and, in the second place, to protect third persons from whom the contractor may obtain materials or labor used in the construction of the improved road. Acts of this kind are intended to furnish the obligation of a bond as a substitute for the security which might be obtained by a mechanic's lien, such liens not being given in the case of public works. Id. at 497, 260 S.W. at 416. See also National Sur. Corp. v. Edison, 240 Ark. 641, 401 S.W.2d 754 (1966) (Smith, J., concurring).
40. Id. at 546, 460 S.W.2d at 56 (citing Holcomb v. American Sur. Co., 184 Ark. 449, 42 S.W.2d 765 (1931)). However, the court has held that a lender who advanced money to a subcontractor on a public contract to pay materialmen and laborers did not gain the status as a "holder of labor and material claims" under the predecessor to Ark. Stat. Ann. § 14-605 (1979). Ayres & Graves v. Ellis, 185 Ark. 818, 49 S.W.2d 1056 (1932). The statute has since been changed to delete this language.
41. Section 71-713(A) provides in part:
Any contractor who for a fixed price, commission, fee or wage, attempts to or submits a bid or bids to construct or contracts to construct, or undertakes to construct, or assumes
lied upon this statute to uphold trial courts' dismissals of suits by unlicensed contractors against contentions that the statute was not intended to apply to unlicensed subcontractors and that the contractor was a mere employee of the owner. The court has also rejected the argument that the statute was not intended to be used by prime contractors as a shield from an unlicensed subcontractor. However, the court has held that the licensing statute does not apply to an unlicensed contractor when the main contract is with the United States Govern-

charge in a supervisory capacity or otherwise, of the construction, erection, alteration or repair, of any building, highway, sewer, grading or any other improvement or structure, when the cost of the work to be done by the contractor, including but not limited to labor and materials, is twenty thousand dollars ($20,000.00) or more, without first having procured a license to engage in the business of contracting in this state, . . . shall be deemed guilty of a misdemeanor, and shall be liable to a fine of not less than one hundred dollars ($100.00), nor more than two hundred dollars ($200.00) for each offense, each day to constitute a separate offense. No action may be brought either at law or in equity to enforce any provision of any contract entered into in violation of this act §§ 71-701—71-720.

42. In Bird v. Pan Western Corp., 261 Ark. 56, 546 S.W.2d 417 (1977), an unlicensed subcontractor went bankrupt after completing its contract to install heating and air conditioning in some Little Rock apartments. The trustee in bankruptcy then brought suit to foreclose upon the mechanics' and materialmen's liens of the subcontractor on the project. The trustee argued that a subcontractor who supplies labor and materials to the prime contractor is not a "contractor" as defined by Ark. Stat. Ann. § 71-701 (1979). Rather, the term "contractor" in the licensing statute was intended to apply only when the contractor contracts directly with the owner. Reviewing the definition of contractor in § 71-701, the court refused to accept the trustee's construction of the statute. Under its subcontract, the subcontractor was to furnish all labor and materials to complete the heating and air conditioning of the apartments in accordance with the plans and specifications and was obligated to correct any defect to the owner's satisfaction.

Under these circumstances [the subcontractor], for a fixed price, contracted to construct, or assumed charge, in a supervisory capacity or otherwise, of the construction, erection, or alteration or had constructed, erected or altered, under its direction a building, improvement or other structure and the cost of the work to be done was in excess of $20,000.

Bird, 261 Ark. at 62, 546 S.W.2d at 420 (court's emphasis). Therefore, the licensing statute would apply to a subcontractor.

43. In Davidson v. Smith, 258 Ark. 969, 530 S.W.2d 356 (1975), the appellee verbally agreed with the appellant to restore a residence to its original condition. After completion, the appellee presented a bill for $57,552.40 which the appellant refused to pay. Deducting a prepayment for materials, the appellee sued for the balance and received a judgment for $8,511.87 plus interest. The Arkansas Supreme Court reversed. Against the assertion that the appellee was only an employee of the owner and not a contractor as defined by § 71-701, the court noted that the appellee had subcontracted for labor and materials, had contracted with the owner on a cost plus 10% basis, and had exercised overall control at the worksite. "We find the evidence preponderates that Smith's activities, pursuant to his cost plus agreement, were not that of a mere foreman or employee and further that Smith was a 'contractor' as defined in § 71-701 and within the standards enunciated in [Arkansas State Licensing Board v. Lane, 214 Ark. 312, 215 S.W.2d 707 (1951)]." Davidson, 258 Ark. at 975, 530 S.W.2d at 359.

ment. The end result is that the failure of the contractor to be licensed may bar recovery from the surety.

One question yet to be answered by the court is whether a licensed subcontractor is barred from recovery against the surety of the prime contractor if his prime contractor is unlicensed. Strict interpretation of section 71-713 would indicate that recovery would be barred. The section clearly says that "[n]o action may be brought either at law or in equity to enforce any provision of any contract entered into in violation of this Act." Enforcement of the subcontract through the prime contractor's surety bond would necessarily involve the enforcement of the prime contract, a contract which cannot be enforced under section 71-713. However, a better position would allow recovery under the prime contractor's bond. First, the court has indicated that, at least when public projects are involved, the liability of the surety is independent of that of the contractor. Second, the surety should not be able to shield itself from its obligation since it approved the contractor's qualifications by issuing the bond. Third, public policy would not be served. The subcontractor, having complied with the licensing requirements, has done all within its power required by statute. Refusing to enforce the surety's obligation would not advance public policy since this action would reward noncompliance while penalizing those who have complied with the licensing law.

IV. Statutes of Limitations

The statutes of limitations have proved to be a major obstacle in recovering on a construction bond. Although the normal statute which

45. Although dismissing the suit as to the surety on the basis that the surety bond was a Miller Act bond under 40 U.S.C.A. § 270a-270e (1986) and therefore the trial court was without jurisdiction, the court in Airport Constr. & Materials, Inc. v. Bivens, 279 Ark. 161, 649 S.W.2d 830 (1983), held that the licensing statute did not prevent an unlicensed subcontractor from maintaining a suit when the main contract was between the prime contractor and the United States Government. The federal government, not the State of Arkansas, had the ultimate power to determine the qualifications of contractors working on federal projects. "Were a government contract subject to interruption because of varying state requirements, when the federal government has already determined that the contractor has the capability to fulfill its requirements and control the project to its satisfaction, the supremacy policy would be largely undermined." Id. at 165, 649 S.W.2d at 832. See also Leslie Miller, Inc. v. Arkansas, 352 U.S. 187 (1956).


47. ARK. STAT. ANN. § 71-713(A) (Supp. 1985).

applies to surety bonds imposes a five-year limitation,\textsuperscript{49} bonds required by statute have a considerably shorter limitation period. Under these statutes, the claimant has only six months from the date of final payment on the contract to file suit.\textsuperscript{50}

This considerable difference in the two time periods has created a principal defense for the surety, a defense which was cited by the court in \textit{Benton County Lumber Co. v. National Surety Co.}\textsuperscript{51} In that case, the appellant brought suit after the six-month limitation but contended that the bond was not a statutory bond inasmuch as the bond was neither filed nor approved by the circuit clerk as required by statute.\textsuperscript{52} The court, however, found the bond to be statutory and thus controlled by the six-month statute of limitations.

We think it clearly appears that the parties intended a statutory bond, and it was executed in all respects as required by the statute, except it was not approved by the clerk. . . . \[T\]he mere fact that they failed to file it with the clerk would not prevent it from being a statutory bond.\textsuperscript{53}

As required by section 51-636, the six-month period begins to run from the date of the "final payment." The term "final payment" was the focal point in \textit{Tucker Paving Corp. v. Armco Steel Corp.}\textsuperscript{54} In that decision the contract required the owner to retain five percent of the contract funds due the prime contractor for the purpose of remedying any minor defects in the project. On February 8, 1965, the project was completed, and the five percent that had been retained was paid to the contractor on June 7, 1965. Unsuccessful in collecting money due for materials, a material supplier to a subcontractor sued on the prime contractor's bond. The contractor and its surety pleaded the statute of lim-

\textsuperscript{49} Ark. Stat. Ann. § 37-237 (Supp. 1983). This statute states that no action in contract to recover damages "caused by any deficiency in the design, planning, supervision or observation of construction" to any real property improvement can be brought more than five years after substantial completion. See City of Hot Springs v. National Sur. Co., 258 Ark. 1009, 531 S.W.2d 8 (1975).


\textsuperscript{51} 179 Ark. 941, 18 S.W.2d 1017 (1929).


\textsuperscript{53} Benton County Lumber Co., 179 Ark. at 947-48, 18 S.W.2d at 1019.

\textsuperscript{54} 242 Ark. 49, 411 S.W.2d 888 (1967).
itations claiming that the term "final payment" in the statute referred to payments received at the time of the completion of the project. The court disagreed and held that payment of the five percent retained on June 7, 1965, constituted final payment.

In the generally accepted use of the word, "final," the meaning is simply "last"—"nothing remains to be done"—"the matter is concluded." We think that the adoption of appellants' argument would do violence to our statute, and that such a holding would create uncertainty as to the beginning of the period of limitations where it presently appears to be quite clear.55

Section 14-606 would also seem to control the statute of limitations for bonds required for state highway projects.56

Although sureties have attempted to shorten the limitations period by contract, the Arkansas court has not been receptive to this action. In Hartford Accident & Indemnity Co. v. Stewart Brothers Hardware,57 a materialman sued to recover against a surety bond supplied under section 51-634 of the Arkansas Statutes Annotated, the statutory provision regulating payment bonds for private contracts.58 The bond provided that no action on the bond could be brought more than one year from the date the contractor ceased work on the project, but that if any limitation provided by the bond was prohibited by law, then the limitation would be that provided by statute. Refuting Hartford's reliance on City of Hot Springs v. National Surety Co.,59 the court repeated the test announced in the City of Hot Springs case. "We held that the parties were free to contract for a limitation shorter than the general five-year statute applicable to written instruments if the stipulated time was not unreasonably short 'and the agreement did not contravene some statutory requirement.'"60 Since the one-year time period from the date the contractor ceased work on the project would have expired prior to the six-month final payment date under section 51-636, the

55. Id. at 53-54, 411 S.W.2d at 890.
59. 258 Ark. 1009, 531 S.W.2d 8 (1975).
60. Hartford Accident & Indem. Co., 285 Ark. at 353-54, 687 S.W.2d at 129.
court held the provision invalid and the bond to be controlled by the six-month period of section 51-636.

Distinguishing the types of obligations assumed by the surety, the court has managed to avoid the harsh effects of the shorter statutes of limitations. One such distinction has been the indemnification the bond seeks to provide. If the bond provides coverage which is not required by statute, the court has held that the bond is a common law bond and is thus controlled by the longer five-year limitation. Assuming the obligation of the contractor upon default and becoming a completing surety will also place the action outside of the six-month limitation period.

V. Default of the Contractor

Without hesitation, one can safely conclude that the default of the contractor creates a critical situation for all parties. The contractor, having defaulted possibly because of financial difficulties, faces not only the prospect of a future lawsuit but also the possible loss of its investment in the project. As the financial guarantor of the contractor's performance, the surety stands to lose up to and possibly above the penal sum of the bond. The owner and the project's lenders, meanwhile, wish to see the project completed within the contract price and in accordance with the project specifications. Therefore, every party is interested in having the project completed at a minimum of additional cost and without incurring any further liability.

Upon default of the contractor, the surety may choose among several options in remedying the default. The surety's choice will depend not only upon satisfying its obligations under the performance bond at a minimum of cost and risk but also on protecting its right to any remaining contract funds and its right of indemnity. Typically, the op-

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62. See infra notes 67-70.

63. In Argonaut Ins. Co. v. M & P Equip. Co., 269 Ark. 302, 601 S.W.2d 824 (1980), the prime contractor defaulted on a road construction project and the surety employed another contractor to finish the construction. More than six months after the final payment, a subcontractor brought suit to recover monies due on the project. Noting that the action was based not on the original surety contract but upon the surety's promise to pay the balance due after the surety assumed completion, the court refused to apply the six-month statute of limitations. The surety's assumption of completion of the contract replaced the surety agreement with a new and different obligation. Contra Southern Sur. Co. v. Simon, 172 Ark. 924, 290 S.W. 960 (1927).

64. Petro, supra note 3, at 539-40.
tions available to the surety are: (1) To persuade the original contractor to return to the job and perform according to the original contract; (2) to pay damages to the owner and various other claimants under the bond up to the penal sum; (3) to do nothing, allow the owner to remedy the default, and indemnify the owner for the cost of completion; (4) to finance the original contractor to enable it to complete; (5) to negotiate an agreement between the owner and a new contractor who will complete the project; or (6) to complete the project itself by utilizing the original contractor or another contractor. Various factors, such as cost, control over the project, and exposure to additional liability, will dictate which option the surety will choose since certain choices will expand the liability or forfeit rights which the surety will normally possess.

As with any other insurance contract, the owner may be required to give notice of the contractor's default to the surety. Although not required in the absence of an agreement, failure to give notice as required by the provisions of the bond has been held to forfeit the bond's protection. However, the owner in giving notice will not be held to any higher standard than required by the bond.

One course of action that the surety may pursue upon the default of the contractor is to complete the contract itself. Often, only a few problems prevent completion of the project, and the surety finds that it is economically advantageous to complete the contract rather than pay damages under the performance bond. This action, however, forfeits the surety's protection of the penal sum of the bond, the usual limit of the surety's liability. The courts have held that by taking over the contract and assuming the liabilities of the contractor, the surety becomes primarily liable under the contract to the owner, and the surety's liabil-

65. Id.; Thompson, Completion Options Available to a Performance Bond Surety Other Than Financing Its Principal, XVII FORUM 1215 (1982).
68. The surety in Nick Peay Constr. Co. v. Miller, 100 Ark. 284, 139 S.W. 1107 (1911) contended that the notice given by the owner was improper, thereby relieving the surety of any liability. The bond required that written notice be given to the surety within five days of default together with a verified statement of the facts. The owner gave notice by letter which stated that the contractor had abandoned the project. Although unsworn, the letter was found sufficient since only the statement of facts, and not the notice, was to be verified.

It is true that this notice was not sworn to, but it was not stipulated in the bond that it should be. Since it advised that the contract had been wholly abandoned by the contractor, it was not necessary to make any further statement of the facts, nor contemplated that it should be further verified . . . .

Id. at 294, 139 S.W. at 1111.
ity is no longer limited by the penal sum. See, e.g., Caron v. Andrew, 133 Cal. App. 2d 402, 284 P.2d 544 (1955); Klein v. J.D. & J.M. Collins, 159 La. 704, 106 So. 120 (1925).

While Arkansas has yet to specifically recognize this theory, the practical effect of the cases in this area has the same result. In Southern Surety Co. v. Phillips, the court held the surety of a highway project liable for various claims which were not covered by the terms of the bond. After the contractor's default, the surety and the contractor executed an assignment which provided that the surety would assume the liabilities of the contractor and would receive money due from the state highway department. In the view of the court, the assignment was a valid contractual obligation which obligated the surety to pay all lawful claims arising from the project. The court, in United States Fidelity & Guaranty Co. v. Sellers, likewise held that the surety had obligated itself as a joint contractor by executing a contract with the owner and the contractor to complete the project. Other Arkansas cases have recognized that one who is a "completing surety" stands in a different position from one who is not.

VI. Coverage of the Bond

Once default on a construction contract occurs, the primary focus centers upon the coverage of the bond. As a surety bond is in reality no more than a contract, the terms of the bond will normally control the question of coverage. The exception to this rule lies in the fact that the terms of certain bonds are controlled by statute.

Two separate sections outline the coverage of statutory bonds. First, section 14-604 of the Arkansas Statutes Annotated requires surety bonds for the repair and construction of public improvements and mandates that the surety shall be liable for:

Claims for labor and materials shall include but not be limited to fuel oil, gasoline, camp equipment, food for men, feed for animals, premiums for bonds and liability and workmen's compensation insurance, rentals on machinery, equipment and draft animals; and also for taxes

70. 181 Ark. 14, 24 S.W.2d 870 (1930).
71. Id. at 24, 24 S.W.2d at 874.
or payments due the State of Arkansas or any political subdivision thereof which shall have arisen on account of or in connection with wages earned by workmen on the project covered by the bond.\textsuperscript{74}

A similar statute, section 51-632 of the Arkansas Statutes Annotated, likewise requires a bond for the construction or repair of public improvements, but the application of this statute is limited to contracts exceeding $10,000.\textsuperscript{75} Its coverage is also similar to that of section 14-604.\textsuperscript{76} Although separate and distinct, these statutes do not contemplate the requirement of two bonds for any one project; rather, the purpose of section 14-604 is to designate certain claims which are to be covered by the bond.\textsuperscript{77} Nevertheless, an obvious difference between the two sections seems to be that section 51-635\textsuperscript{78} would require a performance obligation whereas section 14-604 would not.

An issue which has arisen frequently has been whether certain materials are within the coverage of the bond, a question which the Arkansas courts have liberally answered in favor of the materialman or laborer. Having supplied various materials and hand tools to a subcontractor on a highway project, the appellee in \textit{National Surety Corp. v. Ideal Lumber Co.}\textsuperscript{79} sued the surety to recover the amount owed on the subcontractor's account. Citing \textit{Heltzel Steel Form \& Iron Co. v. Fidelity \& Deposit Co.},\textsuperscript{80} the surety defended on the ground that the

\textsuperscript{74} ARK. STAT. ANN. § 14-604 (1979).
\textsuperscript{75} No contract in any sum exceeding $10,000 providing for the repair, alteration, or erection of any public building, public structure or public improvement shall be entered into by the State of Arkansas, or any subdivision thereof, any county, municipality, school district, other local taxing unit, or by any agency of any of the foregoing, unless the contractor shall furnish to the party letting the contract a bond in a sum equal to the amount of the contract.


\textsuperscript{76} ARK. STAT. ANN. § 51-635 (1971) states that the bond required under ARK. STAT. ANN. § 51-632 shall cover the contractor's performance of the contract and shall pay for labor or materials furnished for the construction or repair. This coverage is also part of bonds for the construction of certain charitable institutions and bonds furnished to private improvements. See ARK. STAT. ANN. §§ 51-633 and 51-634 (1971), respectively.


\textsuperscript{78} ARK. STAT. ANN. § 51-635 (1971).

\textsuperscript{79} 249 Ark. 545, 460 S.W.2d 55 (1970).

\textsuperscript{80} 168 Ark. 728, 271 S.W. 325 (1925). Therein, the appellant had sued to recover the purchase price of steel forms used to construct a road. The court held that while the forms may have been essential to the construction, they fell outside of the bond's protection since they did not become part of the constructed improvement. See also Pierce Oil Co. v. Parker, 168 Ark. 400, 271
tools formed no part of the improvement and therefore were not protected by the bond. The court nevertheless held the tools to be within the coverage of the bond. Without much explanation, the court noted that the case of Detroit Fidelity & Surety Co. v. Yaffee Iron & Metal Co. had changed the Heltzel rule. The apparent reason for the distinction between the cases is the wording of the statutes. In Heltzel, the surety bond had been based upon section 5446 of the Crawford and Moses Digest. Similar in wording to section 51-635 of the Arkansas Statutes Annotated, the statute allowed claims for those supplying labor and materials to the project. The statute in Ideal Lumber and Yaffee Iron was section 14-604, which by its own terms covers materials or labor not incorporated into the project but necessary for its construction. The distinction becomes important if a bond was required by section 51-635 but not by the terms of section 14-604. In that instance, the bond's protection would cover only labor and materials incorporated directly into the project if the Heltzel decision is followed.

Outside the question of whether the materials have been incorporated into a specific project, the court has limited the coverage of such bonds. For example, the court in Fausett Builders, Inc. v. Globe Indemnity Co. held that the owner could not recover from the surety on a performance bond the amount of attorney's fees spent defending claims filed after the default of the contractor. Since the contract was one of ordinary suretyship rather than an indemnity agreement, the court reasoned that the right of recovery against the surety did not extend beyond the liability of the contractor. No agreement to reimburse the owner existed; therefore, the surety also was held not liable. In addition, the court has refused to hold a surety company liable for goods sold to a subcontractor when the goods were never used nor in-

S.W. 24 (1925).
81. 184 Ark. 1095, 44 S.W.2d 1085 (1932).
83. Contractor's bond. All contractors shall be required to give bond for the faithful performance of such contracts as may be awarded to them with good and sufficient security in an amount to be fixed by the board of commissioners, and said bond shall contain an additional obligation that such contractor, or contractors, shall promptly make payment to all persons, supply him, or them, labor and materials in the prosecution of work provided for in such contract. Suit may be brought by and in the name of the district upon the bond given to the board. Any person, individual or corporation supplying labor and material shall have the right of action, and shall be authorized to bring suit in the name of the district for his, their, or its use and benefit against said contractor and surety, and to prosecute same to final judgment and execution, but such action and its prosecution shall involve the district in no expense whatsoever.

Crawford and Moses Digest of the Statutes of Arkansas § 5446 (1921).
84. 220 Ark. 301, 247 S.W.2d 469 (1952).
tended to be used on the bonded project. 85

To determine which parties supplying materials or labor are covered by the bond, the court has distinguished between the obligations under common law bonds and statutory bonds. If the bond is a common law obligation, its terms control the coverage. The surety may extend or restrict the coverage as it pleases since the contractual terms control. 86 The coverage of a statutory bond, on the other hand, must conform to the statute, 87 and the court in Sweetser Construction Co. v. Newman Brothers, Inc. adopted the "privity of contract" rule to determine which parties may claim against the bond. 88 Stated simply, the supplier must be in privity with the principal before he can recover on the bond. In Sweetser Construction Co. the contractor agreed to build a dormitory for the University of Arkansas and furnished a bond pursuant to sections 51-632 and 51-635 of the Arkansas Statutes Annotated. Sweetser Construction placed an order for materials with Fort Smith Structural Steel Company which, in turn, contracted with United Iron and Steel Company. United then purchased the materials from the appellee. Appellee later brought suit against Sweetser Construction and its surety for the purchase price. Reversing the lower court's ruling, the Arkansas Supreme Court held that the supplier must be in privity of contract before it can recover on the bond.

"[O]ne who supplies material to a materialman, who in turn supplies the subcontractor, is to be relegated to the status of a stranger to the original contract, since such person's contract or undertaking is neither with the principal contractor, nor with one who, as in the case of a subcontractor, deals directly with the principal contractor. Such person's contract is therefore but indirect and collateral to the original contract, and for want of privity does not serve to bring such party within the purview of the principal contractor's bond." 89

The court was quick to point out, however, that coverage would be af-

87. "The bond sued on is a statutory bond, and such bonds executed in the form prescribed by the statute are to be construed, as respects the rights of both principal and surety, as though the law requiring and regulating them were written in them." New Amsterdam Casualty Co. v. Detroit Fidelity & Sur. Co., 187 Ark. 97, 100, 58 S.W.2d 418, 419 (1933). See also River Valley, Inc. v. American States Ins. Co., 287 Ark. 386, 699 S.W.2d 745 (1985); Faussett Builders, Inc. v. Globe Indem. Co., 220 Ark. 301, 247 S.W.2d 469 (1952); Detroit Fidelity & Sur. Co. v. Yaffee Iron & Metal Co., 184 Ark. 1095, 44 S.W.2d 1085 (1932).
89. Id. at 943, 371 S.W.2d at 517 (quoting City of St. Louis v. Kaplan-McGowan Co., 233 Mo. App. 789, 108 S.W.2d 987 (1937)).
forded to a materialman supplying materials directly to a subcontractor. 90

Although yet to be addressed by the Arkansas courts, the question of the surety's liability for torts committed by the principal against third parties has been the subject of some debate. For the most part, this contention has not received much support from the courts. Only one Louisiana case, Bullard v. State, through the Department of Transportation and Development, 91 has held a surety liable for tort claims. However, the overwhelming majority of the decisions have not allowed tort claims against the surety, reasoning that a surety bond is not a general liability policy but a limited purpose fund for the benefit of those persons covered by the bond and applicable statutes. 92 One such case is Tri-State Insurance Co. v. United States, 93 an Eighth Circuit decision arising out of the Western District of Arkansas. In that decision, the United States sued the owner, lender, and surety for damages it sustained for loss of lateral support which occurred during the construction. Although the language of the bond broadly indemnified against all damages suffered by the owner for the failure of the contractor to perform its contract, 94 the court held that the terms of the bond were not so broad as to allow a third-party tort claim since the surety's obligations were based upon the contractor's nonperformance of the contract. 95

90. Id. at 943-44, 371 S.W.2d at 517-18.
91. 394 So.2d 626 (La. Ct. App. 1980). In Bullard the bond stated that it would indemnify against "any loss or damage of whatever kind and character arising or occasioned by deeds of negligence" by the principal or its agents. Id. at 627-28. Refusing the surety's defense that the bond was a statutory bond and therefore any language outside of the statute was meaningless, the court held that the statutory provisions did not prohibit the surety from providing coverage not required by the act and that the surety was bound by the terms of the bond.
92. See Barker, Third-Party Tort Claimants and the Contract Bond Surety, 5 THE CONSTRUCTION LAWYER 7 (Spring 1984); see also Perry, Third-Party Tort Claimants Can Recover Against Sureties Under Construction Bonds: Is the Bond a Comprehensive General Liability Policy?, 5 THE CONSTRUCTION LAWYER 5 (April 1985).
93. 340 F.2d 542 (8th Cir. 1965).
94. Id. at 543-44, n.1.
95. Even if the seemingly broad language obligating appellant to indemnify the obligees for all cost and damage incurred as a result of the contractor's failure to fully perform its contract is taken as impliedly for the benefit of appellee, a recovery would still be conditioned upon a showing that the building contract was breached. Here, the architect acting as agent for [the owner] specifically instructed the contractor not to backfill until after the time the damage complained of occurred. While the [United States'] right to property damages caused by the removal of the lateral support may be absolute as against the adjoining landowner under the law of Arkansas and other jurisdictions as well, this is not to say that the surety's obligation is converted to one of absolute liability beyond the terms of its bond which guarantees only performance as agreed upon by
VII. Subrogation Rights of the Surety

One of the privileges which the surety enjoys is its equitable right of subrogation. A surety who is forced to complete the construction contract or pay laborers and materialmen because of the principal’s default is subrogated to the rights of the principal and also those of the owner, the subcontractors, and the materialmen. The surety is required to pay the entire debt of the principal before the right of subrogation arises. Although the right of subrogation exists independently of any agreement between the parties, this right can be modified by contract. Nevertheless, the right is not absolute and may be lost through such actions as the failure of the surety to issue a policy through an Arkansas agent.

Most often, the remaining funds due the principal under the construction contract are the subject of the subrogation rights. Once the amounts due the owner, the subcontractors, and materialmen are paid, however, the competition for the remaining funds is generally between the surety and the lender financing the principal. The lender, having advanced funds to the principal and taken an assignment of the contract funds due the principal, will claim the remaining funds due the principal on the contract, while the surety will claim the remaining funds under its subrogation rights. The competing claims result in a

the contractor and the owner-obligee.

Id. at 546.


97. Fidelity & Deposit Co. v. Merchants & Farmers Bank, 120 Ark. 519, 179 S.W. 1019 (1915); 83 C.J.S. Subrogation § 59 (1953).


100. Peay v. Southern Sur. Co., 141 Ark. 265, 216 S.W. 722 (1919). The court in Peay upheld the surety's right of subrogation against the contractor's contention that the claim paid by the surety was invalid. Noting that the surety contract provided that the contractor would indemnify the surety for all good faith payments, the court expanded the subrogation rights of the surety to conform with the contract.

101. American Fidelity Fire Ins. Co. v. Builders United Constr. Inc., 272 Ark. 179, 613 S.W.2d 379 (1981). In this case, the surety policy had not been issued by an Arkansas agent as required by ARK. STAT. ANN. § 66-2221 (1980). Following the rule that a contract prohibited by statute is void, the court refused to allow the surety to recover money paid on the contractor's behalf. See also ARK. STAT. ANN. § 14-605 (1979) (bonds required for public construction contractors must be issued by a surety company licensed to do business in Arkansas and executed by a licensed local agent) and ARK. STAT. ANN. § 51-635 (1971) (bonds for private building contractors, churches, or charitable institution must be executed by a surety company authorized to do business in Arkansas).
classic battle between claimants over a limited, and often inadequate, fund.

In such cases, the surety has gained the superior position. Once the surety has fully performed the principal's obligations, the surety's subrogation rights vest and relate back to the time of the execution of the bond.

Under the doctrine of equitable subrogation a surety taking over and completing the contract of the defaulting contractor is subrogated to the rights of the contractor with respect to the funds due the contractor. Such rights are superior to those of a mere assignee of the money. These rights become vested at the time the surety provides full satisfaction for default and relate back to the time the bond or contract of suretyship was entered into.108

The claim of subrogation will extend to the amount of funds expended by the surety as required by the bond but will not extend to those items for which the surety had no obligation under the bond.108

The surety's recovery, however, may not be limited to the remaining contract funds. The assignee lender may also be exposed to liability for the principal's failure to perform. Although stating its decision was a narrow one, the court in Benton State Bank v. Warren104 held an assignee lender liable for the assignor contractor's failure to pay laborers and materialmen. In that case, monthly progress payments were made to the contractor for ninety percent of the work performed the preceding month. As security for money advanced to it, the contractor assigned its progress payments to the lender. Typically, the contractor would apply for a progress payment from the lender who would in turn send it to the owner along with a request that the check be payable to the lender and the contractor. In addition, the contractor would certify to the lender that materialmen and laborers had been paid. Stating that the decision was based upon which party, the owner or lender, was more at fault, the court cited Farmers Acceptance Corp. v. DeLozier108 and the provisions of section 85-9-318(1) of the Arkansas Statutes Annotated.108 The court affirmed the lower court's decision that the owner

104. 263 Ark. 1, 562 S.W.2d 74 (1978).

Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 [§ 85-9-206], the rights of an assignee are subject to (a) all the terms of the contract between the account debtor and
could recover the progress payments from the lender.  

If the Benton State Bank decision is followed, the contest between the surety and the lender may turn from a battle over remaining funds to a contest over the lender's potential liability pursuant to the assignment. Although the court relied heavily upon the facts of that particular case, the case illustrates the present split of authority over the impact of section 9-318(1) of the Uniform Commercial Code as to whether an affirmative liability upon the lender is created by that section, or whether the section only allows the interposition of defenses against an action by the lender. Nevertheless, Benton State Bank contradicts the general rule that an assignment of rights is not normally a delegation of the duties of the assignor unless there is an express assumption by the assignee, or the circumstances indicate otherwise.

Conclusion

For the most part, Arkansas law provides few surprises in the area of construction bonds since the decisions have generally followed the majority positions. Nevertheless, some questions, such as the extent that a surety's obligations will be extinguished upon a premature progress payment and the expanded liability of a completing surety, have yet to be either presented to or clearly answered by the court. Overall, the decisions demonstrate a conservative approach.

However, some Arkansas decisions may prove to be significant. Benton State Bank v. Warren may signal an opportunity of the surety to recover funds from a lender who has received progress pay-

assignor and any defense or claim arising therefrom; and (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

107. 263 Ark. at 6-7, 562 S.W.2d at 77.


109. Unless the language or the circumstances indicate the contrary, as in an assignment for security, an assignment of "the contract" or of "all my rights under the contract" or an assignment in similar general terms is an assignment of the assignor's rights and a delegation of his unperformed duties under the contract.

Newton v. Merchants & Farmers Bank of Dumas, 11 Ark. App. 167, 171, 668 S.W.2d 51, 52 (1984) (quoting from RESTATEMENT (SECOND) OF CONTRACTS § 328(1) (1979)). Therein, the court held that an assignee lender of a subcontractor did not assume the contractor's obligation to pay materialmen and laborers and that it was entitled to the remaining contract payments as against the prime contractor.

110. See supra notes 29-31.

111. See supra notes 67-70.

112. See supra notes 98-103 and accompanying text.
ments pursuant to an assignment. Although the court stated that its holding was a limited one, the principle behind the decision, coupled with the surety’s right of subrogation, could prove to be a powerful weapon to recover funds received by the lender. Lenders may find themselves facing an entirely new type of liability, which was probably never intended or contemplated. On the other hand, the court may stand by its caveat and severely restrict the effect of the decision. For now, one can only speculate whether the rights and liabilities of sureties will be expanded or diminished.