



The Economics of a Default on a \$1 million NON-bonded Project

(Assumes two subcontractors and two material supply companies)

- Contractor faces potential loss of several hundreds of thousands of dollars, files bankruptcy, and goes out of business; four to five employees are laid off and need to collect unemployment. Contractor completes half of the work and is paid \$500,000, which is an asset being used to pay all the contractor's outstanding debts.
- Subcontractor #1 doesn't get paid for \$200,000 of work performed, possibly goes out of business, and/or has to lay off five to ten employees.
- Subcontractor #2 doesn't get paid for work performed and loses \$200,000-\$300,000 and faces bankruptcy and/or has to lay off five to ten employees.
- Material supplier #1 doesn't get paid for \$100,000-\$200,000 of material from either contractor or subcontractor #1 & 2 since they didn't get paid.
- Material supplier # 2 doesn't get paid for \$100,000-\$200,000 of material from either contractor or subcontractor #1 & 2 since they didn't get paid.
- State has to rebid the project, and the cost is now \$1,300,000. Because the original contractor really didn't know what it was doing, the work done is partially faulty so now the new replacement contractor wants to be paid to correct the defective work plus the original cost of the work.

Total Cost to the State = \$1,800,000

Loss to Four Small Businesses = \$600,000 to \$900,000 plus loss of five to twenty jobs from subcontractors going out of business and/or layoffs

Had this project been bonded, the only cost to State would be the \$1 million plus about 2% for the cost of the bond. All subcontractors and material suppliers would be guaranteed payment by the surety if a default occurred. An actual default would be less likely because the surety would have done a thorough job of reviewing the contractor's capacity, capital, and character during the prequalification process. The benefit of a surety bond not only is that the surety ensures contract completion and subcontractor and supplier payment should the contractor default, but also that the surety undertakes the investigation and review upfront to make sure that there is less of a chance that the contractor will default. The surety's underwriting process ultimately results in more experienced and knowledgeable small businesses, since the surety asks questions and provides advice on what a company has to do to obtain a bond.