Department of Legislative Services

Maryland General Assembly
2008 Session

FISCAL AND POLICY NOTE
Revised

House Bill 312 (Delegate Morhaim, *et al.*)
Health and Government Operations Education, Health, and Environmental Affairs

Procurement - Security Requirements - Extension of Sunset Provision

This bill extends for five years the State law that allows procurement officers to accept bid, performance, and payment bonds issued by individual sureties from bidders and offerors for State procurement contracts. Chapter 299 of 2006, which is scheduled to sunset September 30, 2009, also increased the maximum value of surety bonds that the Maryland Small Business Development Financing Authority may issue from $1 million to $5 million. The bill also clarifies the form required for affidavits of individual surety and requires the procurement advisor to the Board of Public Works to submit biennial, rather than annual, reports to the Governor and the General Assembly regarding the effectiveness of Chapter 299.

Fiscal Summary

State Effect: Potential increase in State expenditures, all funds, due to the increased financial risk from accepting individual surety bonds as security for State contracts through FY 2014. That could be offset by reduced costs of procurements due to increased competition for State procurements. Procurement officers in State agencies could handle the increased workload necessary to investigate the validity of individual surety bonds with existing resources, but that could delay contract award in some circumstances.

Local Effect: None.

Small Business Effect: Potential meaningful. The bill could increase the number of new small businesses that will be able to obtain bonding necessary to bid on State contracts. However, it could also increase their exposure to fraudulent sureties.

Analysis

Current Law: Chapter 299 of 2006 allowed contractors to submit individual surety bonds, or any other security authorized by federal or State regulation or that is satisfactory to the procurement unit awarding the contract, to meet the requirements for bid and performance bonds on certain State procurements. Individual surety bonds are only acceptable if (1) the contractor has been denied corporate surety credit; (2) the individual surety transacts business through a licensed insurance agency; and (3) an affidavit and UCC-1 filing as specified in the bill are provided with the bond. Assets allowed by the bill are:

- cash or certificates of deposit;
- cash equivalents or other assets held by a federally insured financial institution, such as an irrevocable trust receipt;
- U.S. government securities;
- stocks and bonds;
- real property that meets criteria specified in the law; and
- irrevocable letters of credit issued by a federally insured financial institution.

The individual surety must pledge one or more of these assets in an amount equal to or greater than the value of the bonds required for the procurement. The law includes additional rules for calculating the value of assets pledged by the surety whose worth varies over time, such as stocks and real estate. Assets pledged by an individual surety may not be pledged to any other purpose until the asset is released by the unit.

On or before September 30, 2007 and annually thereafter through September 30, 2009, the procurement advisor appointed by the Board of Public Works must report to the Governor and the relevant committees of the General Assembly on the law's implementation during the preceding fiscal year. The report must include an analysis of the bill's impact on small businesses and minority business enterprises.

Surety bonds issued by the Maryland Small Business Development Financing Authority (MSBDFA) may not exceed $5 million.

Background: A surety bond is a three-way contract between the State, a contractor, and a surety (typically an insurance company or other established financial company). Surety bonds require the surety to cover any losses incurred by the State if the contractor defaults or otherwise cannot complete a project as promised. Contractors purchase surety bonds in part to assure those seeking their services that they are legitimate businesses and provide reliable services.

An individual surety bond obliges an individual rather than an insurance company to cover the financial losses incurred by the State in the event of a default by a contractor. Individual surety bonds must provide evidence that the individual has the financial resources necessary to cover possible losses.

Bid bonds are one type of surety bond that provide assurance that a given bid has been submitted in good faith and that the contractor intends to enter into the contract at the price bid. Bidders or offerors on State construction contracts must provide a bid bond if the contract is greater than $100,000 or if federal law requires it. The bid bond must be for at least 5% of the value of the contract or for an amount determined by the procurement officer if the bid or proposal provides only a rate but not a total price. State procurement officers have the option of requiring bidders or offerors on contracts for services, supplies, or construction-related services to provide a bid bond if the contract amount exceeds $50,000. If bid bonds are required, procurement officers determine the value of the required bonds.

Performance bonds are another type of surety bond that protect the State from financial loss if a contractor or bidder defaults on a State contract; they oblige the surety to cover any loss incurred, up to the value of the bond. On State construction contracts that exceed $100,000, contractors must purchase a performance bond for an amount deemed appropriate by the agency's procurement officer. On other State contracts for services, supplies, or construction-related services that exceed $100,000, procurement officers have the option of requiring contractors to purchase performance bonds.

MSBDFA was created by the General Assembly in 1978 to assist socially or economically disadvantaged entrepreneurs in creating and expanding Maryland businesses. MSBDFA's Surety Bond Program assists eligible small businesses in obtaining bid, performance, or payment bonds necessary to perform on local, State, or federal contracts. It may either guarantee a bond from a commercial surety or issue its own surety bonds; the vast majority of the program's activity involves issuing its own surety bonds.

Individual sureties have increasingly drawn the attention of state and federal insurance regulators. Since 2005, insurance commissioners in Texas and Montana have shut down fraudulent individual sureties that sold bonds that were not backed by sufficient resources. The New Mexico Department of Insurance and the U.S. Department of the Interior have also launched separate investigations into the operations of individual sureties in New Mexico. A federal grand jury in New Orleans recently indicted an individual surety for fraud in a case that had been investigated by the Federal Bureau of Investigation. In Maryland, the Board of Public Works advises that since the enactment of Chapter 299, one individual surety bond has been presented for a State procurement, and it was rejected by the procurement officer.

State Fiscal Effect: Given Maryland's limited experience with individual sureties and the potential for fraud in that sector, allowing individual surety bonds to be presented for State procurements increases the financial risk to the State. If a contractor with a fraudulent bond defaults on a State contract, the State will have no means to recoup any financial losses stemming from the default. Admittedly, procurement defaults are rare occurrences, but the potential for damage exists.

At the same time, expanding the availability of bid and performance bonds to firms that have been unable to secure bonding from licensed insurers could increase competition for State procurement contracts. Firms that previously were excluded from bidding on State contracts because they could not secure bonding might be able to secure the bonding they need from individual sureties. Increased competition for State contracts should result in lower contract awards.

Prior to the enactment of Chapter 299, several State agencies advised that they lacked both the staff and expertise to assess the validity of individual surety bonds. At the time, Legislative Services concluded that they could perform their due diligence with existing staff and resources, and still believes that to be the case. Pursuant to regulations adopted to implement Chapter 299, BPW has incorporated training on assessing the validity of individual surety bonds into annual workshops for procurement officers. Yet, given the potential for fraud, the added due diligence required for individual surety bonds could, in some cases, delay contract award.

Small Business Effect: As noted above, small and minority-owned businesses often have difficulty obtaining bonds from established surety companies, which can require evidence of past performance or financial stability. By continuing to give small contractors the option of obtaining individual surety bonds from people who know them, and by maintaining the higher limit on surety bonds issued by MSBDFA, this bill could facilitate their obtaining the bonds necessary for State contracts. That, in turn, could increase small business participation in State procurements.

Unfortunately, some of the fraudulent individual sureties cited above have targeted vulnerable small businesses. In announcing the forced closure of a fraudulent individual surety, the Texas Insurance Commissioner noted, "It appears [he] has been targeting low-income, minority, and women-owned businesses when selling unauthorized surety bonds. Sale of these fraudulent bonds poses a significant threat to Texas businesses…"

Additional Information

Prior Introductions: None.

Cross File: None.

Information Source(s): *Albuquerque Journal*, Texas Department of Insurance, Office of the Montana State Auditor, Federal Bureau of Investigation, Department of General Services, Board of Public Works, Department of Legislative Services

Fiscal Note History: First Reader - February 4, 2008
mll/rhh Revised - House Third Reader - March 18, 2008

Analysis by: Michael C. Rubenstein

Direct Inquiries to:
(410) 946-5510
(301) 970-5510