Department of Legislative Services

Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

Senate Bill 377 (Senator Conway)
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. That law, Chapter 299 of 2006, which is scheduled to terminate September 30, 2014, also increased the maximum value of surety bonds that the Maryland Small Business Development Financing Authority (MSBDFA) may issue from $1 million to $5 million.

The bill takes effect July 1, 2014.

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 until FY 2020. That risk may be offset by reduced costs of procurements due to increased competition for State procurements. Procurement officers in State agencies can handle the increased workload necessary to investigate the validity of individual surety bonds with existing resources, but that may delay contract award in some circumstances. No effect on revenues.

Local Effect: None.

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

Analysis

Current Law: Chapter 299 of 2006 allows 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, are provided with the bond. Assets allowed under Chapter 299 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.

Though initially authorized for three years, Chapter 266 of 2008 extended the termination date for Chapter 299 by five years, until September 30, 2014.

Chapters 299 and 300 of 2012 make it a fraudulent insurance act for an individual surety to solicit or issue a surety bond or contract of surety insurance. This prohibition, however, does not apply to (1) contractors who are authorized to submit individual surety bonds to meet the requirements for bid and performance bonds on certain State projects and (2) uncompensated bail bondsmen operating in circuit courts.

Chapters 299 and 300 also required the Maryland Insurance Administration (MIA) to conduct an analysis of the practices of corporate sureties and individual sureties in the State. MIA submitted a final report to the General Assembly in November 2013.

Background:

Sureties and Surety Bonds

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.

Since its inception in 1984, MSBDFA's Surety Bond Program has issued or guaranteed security for 109 projects, totaling $59.3 million of financial assistance. Of those, nine projects defaulted, resulting in total payouts of $2.4 million. In fiscal 2013, the program approved four applications for security for a total of $3.3 million. MSBDFA reports that it does not have the financial capacity to support $5.0 million in bonding to a single client, but that approval of bonding lines of credit up to $2.0 million are anticipated.

MIA Findings and Recommendations

In its final report to the General Assembly, MIA recommends that the current exemption that allows individual sureties to issue bid, performance, and payment bonds on State contracts should terminate as scheduled on September 30, 2014. MIA found that individual sureties are far more likely than corporate sureties to be sanctioned by state insurance regulatory agencies and that there is no evidence that corporate sureties are unable to meet the needs of the surety market. Specifically, MIA found that, since 2006, only one corporate surety has been sanctioned by a state regulatory agency, compared with 12 individual sureties sanctioned a total of 26 times by 14 different states over the same time period. Moreover, it found that many of the individual sureties who were sanctioned were operating fraudulently and often using aliases in different states.

Only two other states, Alaska and Hawaii, allow the use of individual sureties under limited circumstances. Between 2006 and 2008, legislation to allow individual sureties to operate failed in North Carolina, New Mexico, and Virginia. MIA did not find any further legislative activity in the states related to individual sureties since 2008.

Finally, MIA found that individual sureties have issued bonds on State or local projects in Maryland just six times since 2006, while the number of bonds issued by corporate sureties has increased by 35.2% over the same time period. In just two of the six instances in which individual sureties were used, contracts were awarded to vendors who presented those bonds. MIA's report describes numerous programs designed to enhance the availability of corporate surety bonds to new, emerging, and small businesses.

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 has no means to recoup any financial losses stemming from the default. Admittedly, procurement defaults are rare occurrences, but the potential for damage exists, as evidenced by MIA's report and MSBDFA's experience.

At the same time, expanding the availability of bid and performance bonds to firms that have been unable to secure bonding from licensed insurers may 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, the Department of Legislative Services concluded that agencies 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, the Board of Public Works 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 may, in some cases, delay contract award.

Small Business Effect: 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 may facilitate their obtaining the bonds necessary for State contracts. That, in turn, may 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): Maryland Insurance Administration, Department of Business and Economic Development, Department of General Services, Department of Legislative Services

Fiscal Note History: First Reader - February 5, 2014
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