**SB 391**

# Department of Legislative Services

Maryland General Assembly
2006 Session

## FISCAL AND POLICY NOTE
**Revised**

Senate Bill 391 (Senators Grosfeld and Haines)
Education, Health, and Environmental Affairs Health and Government Operations

---

**Procurement - Security Requirements**

---

This bill allows individual surety bonds that meet criteria specified in the bill to fulfill requirements for bid and performance security associated with State procurements. It also increases the maximum value of surety bonds that the Maryland Small Business Development Financing Authority may issue from $1 million to $5 million.

The bill terminates September 30, 2009.

## Fiscal Summary

**State Effect:** Potential increase in State expenditures due to increased financial risk from accepting individual sureties as security for State contracts could be offset by reduced costs of procurements due to increased competition for State procurements. Regulatory changes and administrative tasks required by the bill can be accomplished with existing resources.

**Local Effect:** None.

**Small Business Effect:** Potentially meaningful. The bill could increase the number of new small businesses that obtain bonding necessary to bid on State contracts.

## Analysis

**Bill Summary:** This bill 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 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 bill; 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 bill 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 bill'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.

The bill applies only prospectively for any required procurement security due after the bill's effective date.

**Current Law:** Other than cash or other securities deemed acceptable by the contracting agency, only surety bonds provided by a surety company authorized to do business in the State are acceptable in the cases where bid or performance bonds are required or authorized by State procurement rules. Individual surety bonds are not acceptable unless so deemed by an agency awarding a contract.

Surety bonds issued by the Maryland Small Business Development Financing Authority (MSBDFA) may not exceed $1 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.

In fiscal 2005, the program approved six new bond transactions, and closed on four of them, obligating $1.2 million in program funds. All of the commitments were for direct bonding lines of credit that clients can use for multiple contracts simultaneously. As of

June 30, 2005, the program had 10 active bonding lines of credit (including some approved in prior fiscal years) totaling $2.4 million.

**State Fiscal Effect:** This bill could insert minimal additional financial risk into the State procurement process. Individual security bonds are not backed by established firms that are regulated by the State and are more likely to be used by newer businesses without extensive work histories that cannot obtain bonds from established financial companies. By requiring individual sureties to transact business only through licensed insurance agencies, the bill minimizes the risk to the State. Nevertheless, allowing contractors to use individual sureties to obtain State contracts increases the financial risk to the State by a minimal amount.

However, the bill could also increase small business participation in State procurements, as described below. Increased small business participation results in greater competition for State contracts, which could reduce State procurement costs.

Procurement offices that accept individual surety bonds from bidders, offerors, and contractors will have to confirm the surety's ownership of all resources pledged for the bond, as well as the value of those resources. These responsibilities can be handled with existing resources.

The bill does not expand MSBDFA's bonding authority or its budget for surety bonds, so there is no direct fiscal impact on the State of raising the cap on the value of surety bonds issued by MSBDFA. However, to the extent that MSBDFA approves larger surety bonds, raising the cap on the value of each surety bond could potentially increase financial risk in State procurement. If MSBDFA awards larger, and therefore fewer, surety bonds with its existing funds, it will be concentrating the State's risk in fewer small business contractors instead of spreading it over more contractors with smaller bonds.

**Small Business Effect:** Small businesses, especially new ones, often have difficulty obtaining bonds from established surety companies, which can require evidence of past performance or financial stability. By giving small contractors the option of obtaining individual surety bonds from people who know them, and by raising the 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.

## Additional Information

**Prior Introductions:** None.

**Cross File:** HB 169 (Delegate Morhaim, *et al.*) – Health and Government Operations.

**Information Source(s):** Department of General Services, Board of Public Works, University System of Maryland, Department of Budget and Management, Surety Association of America, Department of Legislative Services

**Fiscal Note History:** First Reader - March 1, 2006
ncs/rhh Revised - Senate Third Reader - March 28, 2006

---

Analysis by: Michael C. Rubenstein

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