SB 851

Department of Legislative Services

Maryland General Assembly
2014 Session

FISCAL AND POLICY NOTE

Senate Bill 851 (Senator Conway)
Finance

Maryland Insurance Administration - Individual Sureties - Regulation

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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 also creates a regulatory framework for individual sureties and requires the Maryland Insurance Administration (MIA) to further study and report on the optimal method to regulate individual sureties.

The bill takes effect July 1, 2014, and terminates September 30, 2019.

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. Special fund expenditures increase by $30,500 in FY 2015 to hire one contractual staff to assist MIA in performing and preparing the required analysis and report and establishing the registration process. Special fund revenues increase negligibly in all years due to individual surety registration fees.

(in dollars)	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
Revenues	$0	$0	$0	$0	$0
SF Expenditure	30,500	0	0	0	0
GF/SF/FF Exp.	-	-	-	-	-
Net Effect	($30,500)	$0	$0	$0	$0

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

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

Bill Summary: The bill defines "individual surety" to mean a person that issues surety bonds or contracts of surety insurance and does not have a certificate of authority issued by the Commissioner.

Registration of Individual Sureties

An individual surety must register and renew registration yearly with MIA on a form provided by MIA. The initial registration form must include (1) the name, address, telephone number, and other contact information for the individual surety; (2) the types of surety bonds and contracts of surety insurance the individual surety intends to write and the aggregate value of each type of bond and contract; (3) the types of procurement projects, contractors, and subcontractors for which the individual surety intends to provide surety bonds and contracts of surety insurance; and (4) any other information MIA considers necessary for regulation of individual sureties. The renewal registration form must include the same information as well as include additional information related to the individual surety's previous or existing bonds, contracts, projects, contractors, and other specified financial information. The annual registration fee is $100.

MIA must review the registration application based on the information in the application and other available information. MIA may also request additional information from the applicant before approving or denying the application. MIA must approve or deny the application within 60 days after receiving the application and any additional information. If MIA does not approve or deny an application or request additional information within the 60-day period, the application is deemed approved. A registration is effective on the date the registration is approved. Unless a registration is renewed, it expires on the first anniversary of its effective date. MIA may revoke or suspend a registration for good cause and in accordance with Title 4 of the Insurance Article (General Requirements for Insurers). An individual surety may continue to solicit and issue surety bonds under existing law without registration until January 1, 2015.

An individual surety may not issue or solicit a bid, performance, or payment bond if he or she has not registered with MIA. It is a fraudulent insurance act for an individual surety to do so unless registered with MIA.

Required Study

The bill requires MIA to further study and report on the optimal method to regulate the activities of individual sureties and MIA must submit a report of its study and recommendations on or before January 14, 2015, to specified committees. The study must research and assess:

- the benefits and costs associated with different levels of regulation including registration, licensure, and certification;
- the anticipated costs to the State of each form of regulation and different means of covering those costs, including specified types of fees;
- appropriate reserve levels and other financial safeguards for other parties in contracts and transactions involving individual sureties;
- appropriate enforcement mechanisms for the regulatory structures proposed, including penalties and procedures tailored to best practices of the individual surety industry; and
- any other pertinent matter that MIA considers appropriate to include.

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. A person that commits a fraudulent insurance act with a value of $300 or more is guilty of a felony and, on conviction, subject to a fine of up to three times the value of the claim and $10,000 and/or imprisonment for up to 15 years. If the value of the claim is less than $300, a person is guilty of a misdemeanor and, on conviction, subject to restitution, a fine of up to three times the value of the claim and $10,000, and/or imprisonment for up to 18 months.

Chapters 299 and 300 also required 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.

State Expenditures: Due to the complexity of the bill's study requirement, MIA advises that one contractual analyst is needed and the Department of Legislative Services concurs. Expenditures increase by $41,172 in fiscal 2015 to hire an analyst for a seven-month period beginning on July 1, 2014, to coordinate meeting activities for the study, perform legal research, prepare the report, and establish the registration process. Thereafter, the bill's requirements can be handled with existing resources.

Contractual Position	1
Salary and Fringe Benefits	$25,818
Other Operating Expenses	4,712
Total FY 2015 State Expenditure	**$30,530**

Because MIA is required to investigate an individual surety in the registration process, procurement officers in State agencies no longer need to investigate the validity of the individual surety bonds. This may result in minimal workload efficiencies.

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): Board of Public Works, Department of Business and Economic Development, Department of Budget and Management, Department of General Services, Maryland Insurance Administration, Department of Legislative Services

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mc/ljm

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