



Under current law, a contractor on a public project in Maryland can provide bid, performance and payment security by depositing cash, by a surety bond from an insurer authorized to do business in Maryland, or by another form of security allowed by regulation. House bill 169 and Senate bill 391, with amendments proposed by the sponsors, would add to the types of acceptable security anything allowed by federal regulations, anything satisfactory to the governmental unit awarding the contract, and a bond provided by an individual surety that met certain conditions set forth in the statute.

Asking a Maryland State or local procurement officer to interpret Federal law or allowing each governmental unit awarding contracts to determine what is acceptable security certainly creates serious problems. We discuss these problems later in this Memo. First, however, we will focus on the provisions regarding individual sureties.

### **Individual Surety Pledged Assets—The State Does Not Hold Them**

The proponents of the bills do not assert that the individual surety will have assets sufficient to meet the obligations of the bonds or, indeed, any assets at all. There is no requirement that the individual have any minimum net worth. The bills rely completely on the assets that the individual surety is required to pledge. The only protection the State or local government unit or the subcontractors and suppliers working on the project will have is the ability of the State to liquidate that collateral pledged by the individual surety and use the proceeds to pay the individual surety's obligations.

The bills as amended, however, do not require that the government be provided any actual assets. The bills state that individual surety must provide only a "UCC-1 filing security interest" for one or more of five types of assets. That is, the government would not hold the asset. It would have a piece of paper describing the asset, and the contracting officer would have to verify that the asset exists and cannot be diverted and would have to liquidate the asset in the event of a default. A mere security interest in even an existing, valuable asset means the contracting officer would have to determine the priority of any other liens on the asset and that it is actually owned by the person making the pledge. In effect, the contracting officer would have to perform the type of due diligence a bank goes through prior to making a secured loan.

### **The Types of Assets to be Pledged Are Not Verifiable**

- **Cash;** The first of the listed types of assets is cash or certificates of deposit. There is no requirement, however, as to who must hold the cash or issue the certificates of deposit. There is no requirement that the issuer of the certificate of deposit be a federally insured financial institution or even that it be located in the United States or, in fact, that it be a financial institution at all.

- **Cash Equivalents;** The second type of asset listed in the amended bills is "cash equivalents held with a federally insured financial institution, including cash equivalents evidenced by Irrevocable Trust Receipts issued by the institution or by an independent trustee in the name of the unit that are issued in accordance with the Uniform Customs and Practice for Documentary Credits (1993-Ultimate) revision of the International Chamber of Commerce (ICC) Publication Number 500." Under this provision, the governmental unit would not necessarily have any contact with the federally insured financial institution, or even know the identity of the institution. It could be given a document from a "trustee," and there is no restriction or standard for who or what could act as such a trustee other than that it be "independent." Thus, the government's only recourse could be against the "trustee" and the trustee could turn out to be insolvent. If there is cash or cash equivalents held by a federally insured financial institution, what is the need for a "trustee?"

The bills would enact into Maryland law a reference to an Irrevocable Trust Receipt as governed by ICC Publication Number 500, but there is no such document in Publication Number 500. The International Chamber of Commerce is a legitimate organization that performs very useful functions in furthering international trade. It does not issue or sanction or regulate or define an Irrevocable Trust Receipt. The bill describes something that is not a document in common use, and would put the contracting officer of the governmental unit in the impossible position of evaluating documents against a non-existent standard.

- **Stocks, Bonds, and LOCs;** The third, fourth and fifth types of assets that can be pledged are United States Government Securities, actively traded stocks or bonds, and letters of credit issued by a federally insured financial institution. If such items were held by the procuring unit or in an escrow account by a federally insured financial institution, they would represent actual value. The bills, however, would allow a "UCC-1 filing security interest" describing such Government Securities, stocks and bonds, or letters of credit. There is no requirement that such securities actually exist and or that they are held by the government unit or a responsible third party.

- **Real Property;** The final type of security, and the only one not subject to the "UCC-1" loophole, is real property in the state of Maryland. The value of real property, however, is always uncertain, and without its own title search and appraisal, the governmental unit will not know whether there is equity in the property. It also will have to foreclose on the property to liquidate any equity.

Although the amended bills state that the asset cannot be pledged for other obligations, as they are written there is no way to enforce or verify compliance with that requirement since the governmental unit does not have possession of the asset or necessarily even know who does have possession.

### **Incorporation of Federal Regulations**

The proposed amendment would require that any real property be in Maryland, but that improvement is reversed by requiring acceptance of anything allowed by federal regulations. Federal regulations, of course, do not address security on state projects. We assume that the intent of the amendment is to make anything acceptable on a federal project automatically acceptable on a Maryland project. The federal regulations require either a corporate surety on

the Treasury Department's Circular 570 listing sureties holding certificates of authority as acceptable sureties or an individual surety that has provided an escrow account at a federally insured financial institution or a lien on real property located in the United States or its outlying areas (FAR §28.203-1). The contents of the escrow account and the valuation of the real property are then set out in the following sections of the regulations. Thus, a lien on property anywhere in the United States or outlying U.S. areas is clandestinely re-inserted into the bills.

Experience with the federal regulations, however, has demonstrated that the problem is not the regulations themselves but their enforcement. Contracting Officers are professionals at procurement not evaluation of security. If there are actual assets on deposit in a federally insured financial institution, they can be used to obtain a certificate of deposit or letter of credit from the institution, and that certificate of deposit or letter of credit can be provided to the State. In this way the bank runs the risk that the assets are not real or are not the property of the individual surety pledging them, and that is a type of risk that banks routinely evaluate.

### **Security Satisfactory to the Unit Awarding the Contract**

Finally, the bills would allow each procuring agency to determine on a case by case basis what security would be "satisfactory to the unit awarding the contract." Current law permits publication of a regulation allowing other forms of security. That process assures notice to interested parties and the opportunity to comment, and it assures equal treatment of bidders. If a procuring agency can decide something is satisfactory from one bidder but not from others, or that something is satisfactory on one job but not on others, it opens the door to abuse and unfair treatment of bidders. It also puts an unreasonable burden on contracting agencies that would have to evaluate all sorts of proposed security to decide if it was satisfactory.

### **Conclusion**

There is a long history of fraudulent individual surety bonds. The Federal regulations have been amended to try to prevent these frauds by requiring that actual assets support such bonds. There is no reason to expose the State of Maryland or local jurisdictions or subcontractors and suppliers to the risk of fraudulent individual surety bonds. The proponents of these bills assert that there will be cash on deposit in a federally insured financial institution to guaranty the individual surety's obligations. If that is the case, then there should be no difficulty identifying the financial institution and giving the State or local governmental unit the ability to secure payment directly from the insured financial institution.