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Testimony for the Committee on Business, Research And Economic Development
February 1, 2005

Re: **LD 58 An Act To Support Payroll Processors**
LD 208 An Act To Lower the Surety Bond Requirement for Payroll Processors

The National Payroll Reporting Consortium (NPRC) is a non-profit trade association whose member organizations provide payroll processing and related services to over one million employers nationwide, covering over one-third of the private sector work force. Payroll service providers have long served an important role in our nation's tax collection system as a conduit between employers and government tax authorities, improving both the efficiency of government tax reporting and collection, and tax compliance.

NPRC participated in hearings in 2004 on LD 1843, which was drafted to address isolated instances of unscrupulous persons collecting tax payments from businesses and failing to transfer such payments to tax authorities. Our testimony from those hearings is attached as additional background material. In essence, while we did not believe that there was a need for additional oversight of the industry, NPRC testified that if enacted, it is critical that the proposed legislation be effective in accomplishing the intended goals.

A worst-case outcome for the state, for Maine businesses and for the payroll processing industry would be if legislation were to create the ***appearance*** of protecting Maine businesses without establishing effective, substantive measures to do so. This would create an environment in which additional incidents and more losses are even more likely than had no legislation been enacted at all, because businesses would have a *false sense of security*, leading to less-careful selection of an appropriate service provider and less oversight of the service provider once selected.

LD 58, An Act to Support Payroll Processors, would repeal the bond requirement and much of the substance of the law enacted in 2004, leaving the Office of Consumer Credit Regulation with responsibility for licensing payroll processors but no authority to examine them, and no requirement for a surety bond. In this environment, unstable processors or even career criminals seeking an opportunity would benefit from a government-issued license and implied government “seal of approval”.

LD 208, An Act to Lower the Surety Bond Requirement for Payroll Processors, would significantly reduce the required amount of the surety bond.

NPRC opposes both proposals. We believe that the 2004 legislation, which has yet to go into effect, struck the right balance in protecting businesses without imposing overly burdensome oversight on the industry, and should be given an opportunity to work. The legislature granted the state administrator the authority to modify the bond terms if bonding is unavailable, and accordingly, the Office of Consumer Credit Regulation recently announced additional accommodations for payroll processors that were having difficulties qualifying for a bond in the form of a "conditional license" status that requires a reduced surety bond of $50,000. Surety bonds of $50,000 usually do not require a CPA audit and are thus easier to obtain. The requirement for a surety bond is a key element in preventing such failures. The section following describes the preventative nature of surety bonds and provides background on their application in similar situations in which a bonded party has temporary custody of funds.

We believe that the Office of Consumer Credit Regulation has taken appropriate action to accommodate payroll processing companies while protecting Maine businesses, and should be given the opportunity to implement the mandate created by the legislature less than one year ago.

If, however, the surety bond provisions are reduced or eliminated, NPRC believes strongly that the disclosure requirements enacted in 2004 should be revised and strengthened to ensure that businesses are aware that a license does not mean that tax funds administered by licensed payroll processors are safe, or that the state is responsible for the safety of client funds. Disclosures should accurately describe the limitations of any regulatory oversight in Maine, and remind businesses that they remain liable for such taxes. Specific recommendations are provided in the final section.

Payroll Service Provider Regulation: The Role of Surety Bonds

I. Background and Purpose of a Surety Bond

Surety bonds are risk management tools. The fundamental purpose of a surety bond is to prevent loss rather than to compensate for loss after the fact.[1] The operative principle is that the surety company will undertake the necessary due diligence to assure that a business or individual will perform a specified task before issuing the bond. Since it is the surety's money that is at risk, the surety must have the experience and incentive to determine that only those businesses that can and will perform the activity can acquire a bond. As such, a third-party who contracts with a business that has acquired a surety bond can be assured that such business has been subject to an investigation as to the business' fitness to perform the obligation protected by the surety bond. The surety acts to pre-qualify the company for the particular business activity[2].

Nature of Scrutiny Performed by a Surety Company

The level of scrutiny of a surety's investigation of a business applying for a surety bond increases with the amount of the bond. Generally, however, the depth of such scrutiny peaks for bonds of approximately $1 million[3]. In other words, a surety will perform the same degree of investigation for a bond of $5 million as it would for $1 million. Thus, to the extent the purpose of a surety bond requirement is to prevent loss by pre-qualifying a business to perform the

[1] A surety bond is different than a fidelity bond. A surety bond ensures performance of a certain activity. The beneficiary of a surety bond is the third-party contracting with the business (i.e., the government in the case of a tax collection surety bond). A fidelity bond protects against the fraud or malfeasance committed by an employee of a business. The beneficiary of a fidelity bond is the business acquiring the bond.

[2] Surety Information Office; www.sio.org; (202) 686-7463

[3] Surety Association of America; www.surety.org; (202) 463-0600

specified activity, the benefits of such a requirement are effectively capped at a $1 million obligation.

For example, to issue a $100,000 bond, a surety will generally examine the most recent year's income statement and balance sheet, but may not require a CPA audit. It will review the personal financial statements of the owners of the business to determine equity outside the value of a company. For this level of bond, it is estimated that the surety would require approximately $300,000 in business and $500,000 in outside equity (in the case of a small business).

To issue a bond for $1 million, however, the surety generally would require 2-3 years of CPA-audited financial statements. It would conduct personal meetings with company executives, including the owner and the CFO; would review Bank Line of Credit Agreements, insurance certificates, key resumes, etc.; and generally would require business equity 3-5 times the value of the bond and perhaps require personal outside equity by owners of a smaller business.

II. Bonding Precedents under Federal and State Law

There are several examples of Federal and state bonding requirements for businesses involved in regulated or quasi-governmental activities. In each case, the statute recognizes that the fundamental purpose of the surety bond protection is to pre-qualify businesses or individuals to perform certain activities and thereby to prevent loss rather than to serve as insurance.

The fuel tax surety bond requirement is akin to the surety bond requirement for payroll service providers. The statute requires that businesses (terminal operators) that collect and remit fuel taxes acquire a surety bond equal to the lesser of $1 million ($500,000 in the case of diesel fuel) or the tax due during an average month.

ERISA requires that fiduciaries of employee benefit plans and other persons who handle funds or property of a plan must acquire a surety bond of not less than 10% of the funds handled, but not more than $500,000. Although the Secretary of Labor has authority to require a bond for more than $500,000, the Secretary has never used that authority.

In 2004, Maine amended its law governing payroll processing companies to require such businesses to purchase a surety bond of $100,000 to $500,000. The state administrator has the authority to modify these bond terms if bonding is unavailable. The Maine Office of Consumer Credit Regulation included a number of elements in the bond form to ensure that surety bond companies would underwrite such bonds; e.g.,

- Provided that all claims be processed through the state administrative agency, eliminating the possibility of liability for outside, third-party claims not related to the mishandling of client funds.
- The bond is cancelable upon 30 days' notice;
- The bond cannot be "stacked" or multiplied from year to year; rather, the maximum liability is limited to the amount of a single bond

In December 2004, the Maine Office of Consumer Credit Regulation announced additional accommodations for payroll processors that were having difficulties qualifying for a bond, in the form of a conditional license that requires a reduced surety bond of $50,000. Surety bonds of $50,000 normally do not require a CPA audit and should be easier to obtain.

In summary, the Office of Consumer Credit Regulation has taken appropriate action to accommodate payroll processing companies while protecting Maine businesses. If the legislature determines that a reduced minimum bond amount is appropriate, we would recommend no less than $50,000. Any less would result in a cursory review by surety companies that would be insufficient to accurately assess the competency and appropriateness of a payroll processing company.

If surety bond requirements were to be removed from the law, we would recommend repeal of the entire law, and instead requiring clear disclosures to ensure that businesses are aware that they remain liable for all taxes, and that the state does not regulate payroll processing companies and assumes no responsibility for their solvency. Suggested disclosure language appears below.

<u>Strengthening Disclosures</u>

(1) Existing Law

LD 1843 provided for two sets of disclosures: An initial disclosure at the time of contracting, and quarterly disclosures to remind businesses to confirm that their taxes are being paid on their behalf.

> *2004 CHAPTER 668 (H.P. 1369 - L.D. 1843)*
> *Sec. 4. 10 MRSA §1495-B, sub-§§3 to 7 are enacted to read:*
>
> *4. Disclosure of methods of verification. On a regular basis not less frequently than quarterly, a payroll processor shall clearly and conspicuously and in easily understood language disclose to each employer for which it provides payroll processing services the specific method or methods whereby each employer can contact state and federal tax and unemployment insurance authorities, including but not limited to Internet address and toll-free telephone number information, to verify that payments have been made and properly credited on behalf of the employer.*
>
> *5. Disclosure of limitations of surety bond. Whenever a payroll processor promotes, markets or advertises itself or its services and uses the phrase "bonded with the State" or "fully bonded" or other language that in the opinion of the administrator would lead an employer to believe that the bond coverage provides full compensation for potential losses should the payroll processor fail to make required payments or become insolvent, the payroll processor shall also include a clear and conspicuous disclaimer stating that use of the language referencing bonding does not signify or ensure that the bond will cover all potential claims if the payroll processor fails to comply with its responsibilities under this chapter. A payroll processor also shall provide this disclaimer to an employer before contracting for payroll processing services to that employer.*

<u>(2) If LD 58, An Act to Support Payroll Processors, is enacted.</u>

Section (5) should be replaced with the following:

> **<u>Before contracting for payroll processing services with an employer, a payroll processor shall also provide a disclosure to the employer that the employer</u>**

remains responsible and liable for all taxes, even if the corresponding funds are transferred to a payroll service provider for subsequent payment to the tax authorities; that the State of Maine does not regulate payroll processing companies and assumes no responsibility for their solvency; and that any bond or insurance maintained by a payroll processing company may not cover all potential claims in the event of losses.

(3) If LD 208, An Act To Lower the Surety Bond Requirement for Payroll Processors, is enacted

Section (5) should be revised as follows:

5. Disclosure of limitations of surety bond. Whenever a payroll processor promotes, markets or advertises itself or its services and **makes any reference to the term "bond", "bonded", "insured", "licensed", "registered", "approved"** ~~uses the phrase "bonded with the State" or "fully bonded"~~ or other language that in the opinion of the administrator would lead an employer to believe that ~~the bond coverage provides full compensation for potential losses should~~ the payroll processor **is subject to regulatory oversight or that funds are in any way protected from loss** ~~fail to make required payments or become insolvent~~, the payroll processor shall also include a clear and conspicuous disclaimer stating that **any bond** ~~use of the~~ language ~~referencing bonding does not signify or ensure that the bond will~~ may not cover ~~all~~ potential claims if the payroll processor fails to comply with its responsibilities under this chapter. A payroll processor also shall provide this disclaimer to an employer before contracting for payroll processing services to that employer.

Before contracting for payroll processing services with an employer, a payroll processor shall also provide a disclosure to the employer that the employer remains responsible and liable for all taxes, even if the corresponding funds are transferred to a payroll service provider for subsequent payment to the tax authorities; that payroll processing companies are required to be registered with the Maine Office of Consumer Credit Regulation, and that the employer should periodically confirm that the payroll processor is in good standing with the Office of Consumer Credit Regulation. Such notice shall identify the website address and phone number of the agency.