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Testimony for the Committee on Business, Research and Economic Development
LD 1878 - An Act to Protect Small 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 workforce.

NPRC participated in hearings in 2004 regarding LD 1843, **An Act to Require Surety Bonding by Payroll Processing Companies**, which addressed instances of unscrupulous persons who had collected tax payments from businesses and failed to transfer such payments to tax authorities. In essence, while we did not believe that there was a need for additional oversight of the industry, NPRC testified that if enacted, any legislation must be effective in accomplishing the intended goals.

NPRC also provided testimony last year concerning LD 58, **An Act to Support Payroll Processors**; LD 208, **An Act to Lower the Surety Bond Requirement for Payroll Processors**; and LD 633, **An Act to Relieve Small Payroll Companies from Excessive Regulation**. We said that the 2004 legislation had struck the right balance in protecting businesses without imposing overly burdensome oversight on the industry, and should be given an opportunity to work.

NPRC applauds the good intentions of Representative Robinson and the several co-sponsors in recognizing that the existing law imposed particular burdens on smaller firms in the industry. The payroll processing industry includes many reputable firms that are responsible and have sound business practices, strong internal controls, third party audits, professional competence and management integrity, which are key elements to the safeguarding of client funds.

This committee approved legislation less than one year ago to make it easier for small payroll processors to satisfy licensing requirements. LD 633 reduced the minimum surety bond to $50,000 from $100,000; reduced fees for smaller service providers, and permitted the administrator to accept letters of credit in lieu of surety bonds. Letters of credit are less costly and easier to obtain than surety bonds. Since the law took effect in January 2005, we understand from the Department of Professional and Financial Regulation that virtually any business that wanted to get a payroll processing license was able to get one.

Government regulation of the payroll services industry can be a double-edged sword. Registration, licensing and surety bond requirements may help to ensure that unscrupulous businesses, or those without sufficient means, are not entrusted with taxpayer funds. But once any government entity is perceived to have provided a stamp of approval of service providers (by issuing licenses, for example), the incentive for businesses who use such services to protect themselves may be eliminated.

All that business owners may hear, when talking to a prospective payroll service provider, is "we are licensed and bonded by the State of Maine." They are likely to believe that their funds are fully insured or guaranteed by a bonding company or the state, and that the state would not hold them responsible for losses caused by a state-licensed service provider. In this respect, taxpayers may actually become less diligent in ensuring that their taxes are properly paid.

The Purpose of Surety Bonds is to *Prevent*

Although no perfect solution for safeguarding taxpayer funds has been developed, requiring service providers to post surety bonds has been the most promising approach to date, primarily because it incorporates a significant third-party review of the service provider's capabilities, fitness and background.[1] The surety company undertakes the necessary due diligence to assure that a business will perform a specified task before issuing the bond. Since the surety's money 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. A client 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].

The level of scrutiny of a surety's investigation of a business applying for a surety bond corresponds with the amount of the bond. Generally, the depth of such scrutiny peaks for bonds of about $1 million[3]. For a $100,000 bond, a surety will typically examine the income statement and balance sheet, but may not require a CPA audit. It will review the personal financial statements of the owners to determine equity outside the value of a company. For a $10,000 bond, there is little substantive examination.

LD1878 would make the existing law ineffective. Reducing the bond amount to, in effect, $10,000 would eliminate the third party review of a service provider's capabilities, fitness and background, which is the strongest protection implemented in the law today. Anyone can qualify for a $10,000 surety bond for the asking.

LD1878 misses the point. Having the state act as guarantor and a source of funds for an additional $40,000, in order to enable those who can not qualify for a $50,000 bond to appear to have a $50,000 bond is misleading. The purpose and function of surety

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[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 (e.g., 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

bonds is to *prevent*, not to establish a pool of money to cover losses. Surety bonds are not available in amounts that would cover actual losses caused by the failure of a payroll service. $50,000 would not begin to cover the losses of a single incident.

In 1996, Mainely Payroll absconded with $2.5 million from just 33 clients. In 2003, Harmon-Baert Associates took $1.1 million from 34 Maine businesses. Is it appropriate to entrust a business that can't qualify for a $50,000 bond with millions of dollars? More to the point, is it appropriate for the state to issue an official state license, giving the licensee access to millions of dollars entrusted to them by hard-working business owners, to someone who can not qualify for a $50,000 bond?

Implicit in any licensing requirement is that people must meet minimum standards to obtain a license. If anyone can get a license, the license becomes meaningless, or worse - - misleading. When this committee took action to prevent malfeasance and catastrophic losses to small businesses, members agreed that not just anyone should be permitted to handle significant amounts of other businesses' tax funds.

If the committee finds that small payroll processors are overly burdened by the existing bonding requirement, NPRC would recommend that, instead of effectively reducing the minimum bond amount to $10,000, the legislature should repeal the bonding requirement altogether, and prohibit payroll processors from making any reference to bonds in marketing materials or advertisements. In this scenario, businesses will at least clearly know that there is no guarantee and that they should protect themselves by verifying that tax payments were received.

The 2004 legislation wisely required payroll service providers to inform clients how to verify that payments have been made on their behalf. But businesses will only verify their tax payments if they realize that they remain responsible and that any bond is unlikely to cover the amounts entrusted to their service provider.

As noted in the prior testimony[4], a worst-case outcome for the state and for Maine businesses would be if legislation created the ***appearance*** of protecting businesses without establishing effective, substantive measures to do so. Additional losses would be even more likely in this scenario than had no legislation been enacted at all, because businesses would have a false sense of security and would be less careful about choosing and overseeing a service provider. LD 1878 would do exactly that: It would maintain the appearance of protecting businesses while removing the strongest substantive protection enacted by this legislature. We urge the committee to remember what it originally set out to do, which is to protect small businesses. We urge each member to vote "no" on LD 1878.

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[4] See www.nprc-inc.org