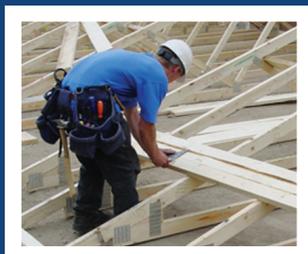


MINNESOTA CONTRACTOR RECOVERY FUND REPORT, 2015



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Minnesota Contractor Recovery Fund Report, FY 2015

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Executive Summary

Contractor Recovery Fund (CRF) payouts increased from \$1.58 million in fiscal year (FY) 2014 to \$1.87 million in FY 2015, an 18 percent increase.

CRF revenues fell 15 percent from \$3.26 million in FY 2014 to \$2.77 million in FY 2015 due to the two-year cyclical nature of residential building licenses.

The CRF operating balance as of FY 2015 climbed to \$5.95 million, rising 16 percent from the FY 2014 fiscal year balance of \$5.14 million. The rise in the operating balance is due to the differential between payouts and revenues. The CRF surcharge reduction in March 2016 will bring revenues and payouts into closer balance.

- In FY 2015, 103 claims were filed against contractors, which involved 46 different contractors. Three cases were resolved by the contractor settling directly with the claimant. Nine cases were denied. Two cases were incompletely filed and returned to the claimant. Five cases were appealed, which left 84 claims paid by the CRF. The total amount of claims paid by the CRF was \$1.87 million and total amount of claims resolved by CRF was \$2.13 million.
- In FY 2015, two contractors accounted for 35 of 37 CRF payouts that involved multiple claims against a contractor.

The multiple claims totaled \$205,394 in FY 2015 and accounted for 11 percent of the CRF payouts.

- The average CRF requested claim amount decreased slightly from \$25,827 in FY 2014 to \$25,801 in FY 2015.
- In FY 2015, administrative expenses were 2.8 percent of revenue.

The CRF was strongly affected by the calendar year (CY) 2006 housing crisis and those effects continue today (see pages 7-8). The number of claims fell from the high of FY 2011's 203 claims to FY 2015's 103 claims. The \$1.87 million paid out in FY 2015, is 36 percent below the \$2.93 million paid in FY 2011.

CRF revenues are more responsive to the market demand for housing stock. As market demand decreases, fewer residential builders acquire licenses. In FY 2015, the number of contractor licenses acquired declined by 4.8 percent. Fewer licensures acted to decrease FY 2015 revenues by 23.1 percent (when compared to the past two-year cycle year, FY 2013). Increased housing demand, coupled with the overall reduction of foreclosure or short-sale stock, should cause revenues and claims to slowly increase during the coming years as more residential contractors enter or re-enter the market.

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Introduction

The Minnesota Legislature created the Contractor Recovery Fund (CRF) in 1974. Amendments to the program were made in 2000 and 2007. The current program is administered by the Minnesota Department of Labor and Industry (DLI) under Minnesota Statutes § 326B.89 (2012 and Supp. 2013).

The CRF compensates homeowners and lessees of Minnesota residential property who have experienced direct out-of-pocket losses as a result of a Minnesota licensed contractor's deceptive actions or nonperformance. Homeowners who suffer losses due to the actions of unlicensed subcontractors or material suppliers are not eligible for CRF reimbursement.

DLI administers the CRF as part of its role in licensing residential building contractors. Licenses are required for all residential building contractors and residential remodelers who contract with a homeowner to construct or improve dwellings by offering more than one special skill. In October 2015, there were 11,862 licensed residential contractors in Minnesota. All licensed contractors in Minnesota are required to maintain professional standards of education and conduct to obtain and maintain their license.

Financial pressures on the CRF are the result of three factors: 1) the number of approved claims against the fund; 2) the amount of those claims; and 3) the revenues generated from licensed residential contractors to fund the program.

Data

This report uses data from DLI's Construction Codes and Licensing Division, including the CRF administrator and the DLI Financial Services unit. Statistics are presented by either fiscal year (FY) or calendar year (CY) as noted. As a general rule, revenue statistics are reported in fiscal years, which begin July 1 and end June 30 of each year. Claims generally carry over fiscal years, so some claims received in CY 2013, prior to the start of the new fiscal year, will not be paid until FY 2014.

Beginning in the 2013 CRF report, all claims are recorded by the date paid rather than by the date received. This change allows revenue figures to be grouped with the payout figures showing a more accurate picture of the fund's health.

CRF Fee revenues were \$2.77M in FY 2015

During FY 2009 to 2015, more than 99 percent of the fund’s revenues came from CRF fees. Other sources of revenue for the fund consist of interest earned and repayments collected from contractors. These reimbursements from contractors average less than 0.5 percent of total CRF homeowner reimbursements.

Fees from each licensed residential building contractor in Minnesota are collected into the state treasury to fund the CRF. In 2015, the \$150 surcharge to the recovery fund that was added in CY 2010 was reduced to \$80. In FY 2016, the CRF fee collected for a two-year license will range from \$480 to \$680, depending upon the gross business receipts of the licensee.¹⁰ The fee structure is shown in Table 1.

Table 1: FY 2016 residential contractor license fees

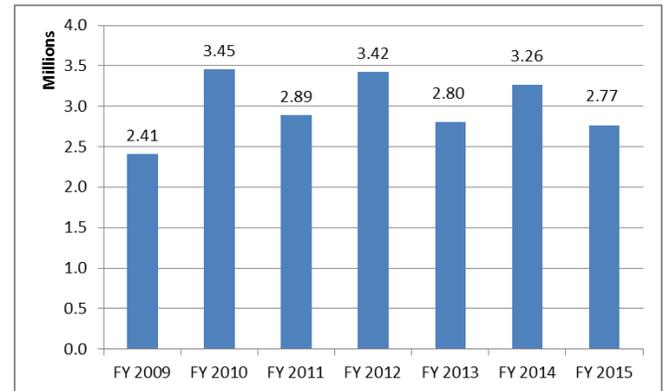
	Tier 1 Contractors (Less than \$1 million in annual sales)	Tier 2 Contractors (\$1 million to 5 million in annual sales)	Tier 3 Contractors (More than 5 million in annual sales)
License	\$160	\$160	\$160
Recovery Fund	\$320	\$420	\$520
Recovery Fund Surcharge	\$80	\$80	\$80
TOTAL	\$560	\$660	\$760

Revenue generated from interest earned has averaged about 1 percent annually.

¹⁰ In 1994, the two-year licensure fee was \$175, \$225, and \$275, dependent upon categorization as outlined in Table 1. A \$150 surcharge was added in 2010 to stabilize the fund.

Total revenues from FY 2009 to FY 2015 are shown in Figure 1. Interest earned income does not have much of an effect on the fund’s health.

Figure 1: CRF revenue, in millions, FY 2009 to FY 2015

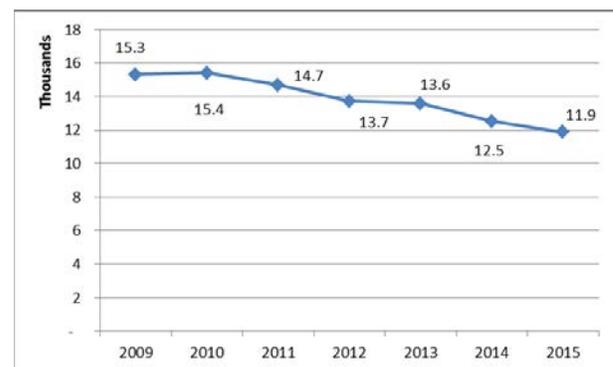


Since the CRF funds are collected with the license fees, the fund’s revenues are subject to the two-year licensure cycle. This effect is clearly shown in Figure 1 with revenues decreasing in odd number years by an average of 17 percent.

Four factors affect CRF revenues:

- 1) The number of residential builders has continued to decline, falling 5.2 percent in FY 2015 and 22.5 percent when measured from FY 2009 (Figure 2).

Figure 2: Number of licensed residential builders in Minnesota



- 2) The CRF portion of the license fees is determined by the gross annual receipts of the residential builder during the previous year. As residential builders' annual receipts decline, so does the licensing fee collected under the CRF program (see Table 1).
- 3) The FY 2010 bump in revenues, shown in Figure 1, was largely due to the \$150 assessment on a two-year license renewal imposed under Minnesota Statutes § 326B.89, subd. 16 (2010).
- 4) Beginning Jan. 1, 2010, licenses were renewed for two years instead of annually, which further increased FY 2010 revenues. This two-year license cycle (reflected in Figure 1) causes the annual revenue fluctuations.

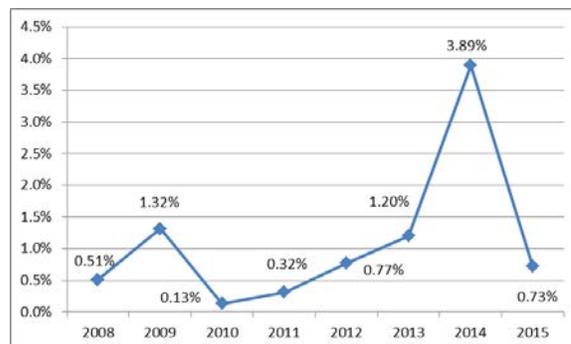
Revenues from contractor reimbursements to the CRF declined in FY 2015

Before the CRF processes a claim for compensation, it notifies the contractor to allow the contractor an opportunity to pay the claim. Contractor paid claims fall into one of two categories either the contractor reimburses the CRF for the amount paid or the contractor directly pays the court-ordered judgment after the claim is filed with the CRF.² DLI has no data about those cases where the contractor directly pays the court-ordered judgment.

Between FY 2008 and FY 2012, contractor reimbursements as a percentage of total CRF paid claims averaged 0.5 percent.

² Statutory incentive for the contractor to pay the claim is provided by Minnesota Statutes §326B.84 (9) (2012). That statute allows DLI to take enforcement action against a contractor's license if the licensee engages in any act or practice that results in compensation paid to a homeowner or lessee from the CRF.

Figure 3: Amount of contractor paid or reimbursed claims as a percentage of total paid claims, FY 2008 to 2015



That percentage rose to 1.2 percent in FY 2013 and to 3.9 percent in FY 2014, before falling to .7 percent in FY 2015. Similarly, total contractor reimbursements during the FY 2008 through the FY 2012 period were \$11,803. Payments increased to \$61,552 in FY 2014 and declined to \$12,421 in FY 2015.

Claim payments

To apply to the CRF for loss compensation, homeowners and lessees must obtain a court-ordered judgment based on a claim of fraudulent, deceptive, dishonest practices, conversion of funds, or failure of performance that arose directly out of the transaction. Typically, there is a two-year lag from the time homeowners or lessees of Minnesota residential property experience a direct out-of-pocket loss as a result of the deceptive actions or the non-performance of a Minnesota licensed residential contractor to the closure of a CRF claim. The majority of this time is spent in obtaining a district court-ordered judgment.

Once a homeowner or lessee's application for compensation is received and all supporting documentation is provided, DLI carefully reviews the material. Then, based upon the CRF statute, DLI makes a

determination of the compensable loss the homeowner or lessee suffered.

Using the collected fees from contractors, the CRF pays compensation to homeowners or lessees who have sought and are eligible to receive compensation under Minnesota Statutes § 326B.89 (2012 and Supp. 2013) and § 326.975 (2006).

The CRF makes payments for claims twice a year based on when the originating incident occurred. For incidents or conduct of a licensed residential contractor that occurred on or before Nov. 30, 2007, the applicant must submit a complete application with all the necessary supporting documentation to DLI by Dec. 1 in order to receive payment by July 15 of the following year. If the claim originated after Nov. 30, 2007, the completed application with all the supporting documentation must be received by DLI by June 1 to receive payment by the following Dec. 1.

Claim limits

Since 1994, the Minnesota Legislature has increased the limits on the amount of compensation a homeowner or lessee can recover from the CRF on three occasions. The current limits are outlined in Table 2.

The Minnesota Legislature limits the amount of compensation that can be paid by the CRF for judgments against each individual contractor (Table 2). Since 2008, claims that have been filed against licensed contractors where this “contractor license limit” (\$150,000 in FY 2008 to FY 2014) was reached, decreased from 38 percent of claims in the FY 2001 to FY 2007 period to 10 percent of claims in FY 2008 to FY 2013. Upon reaching the “contractor license limit,” the fund must pro-rate homeowners’ claims³ as shown in Table 2. When a homeowner’s claim exceeds the limit for an individual claim the amount is reduced to the maximum allowed.

Table 2: Contractor Recovery Fund limits for payments to homeowners or lessees, FY 2008 to FY 2015

	FY 2008 to FY 2014	FY 2001 to FY 2007
Maximum homeowner or lessee claim limit for each incident	\$75,000	\$50,000
Maximum CRF payout for each contractor license	\$150,000	\$75,000

In FY 2015, there were 24 prorated claims (due to the contractor limit being reached). These pro-rated claims involved three contractors, amounting to 23.3 percent of all claims. Nine claims were denied, five were returned for insufficient information, and one claim is on appeal. An additional two

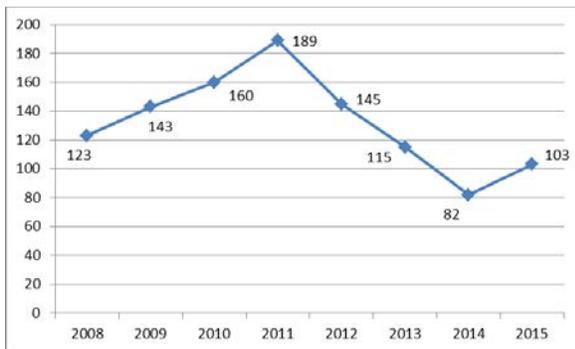
³ The proration formula is: (Approved claim amount/Total amount of approved claims against the contractor) multiplied by the amount available to pay claims against the contractor.

applications were made for reimbursement that exceeded the \$150,000 limit.

Number of requested claims in FY 2015 was 103

From FY 2008 to FY 2011, the number of complete claims received increased peaking at 189 in FY 2011. In FY 2012, the annual number of complete claims for reimbursement declined to 145 and fell to 82 by FY 2014 before they rose again in FY 2015 (Figure 4). Considering the two-year time lag for claims as discussed on page 3, the number of FY 2015 claims fell below the FY 2008 level by 16 percent, when the housing crisis began.

Figure 4: Annual number of complete claims received by the CRF

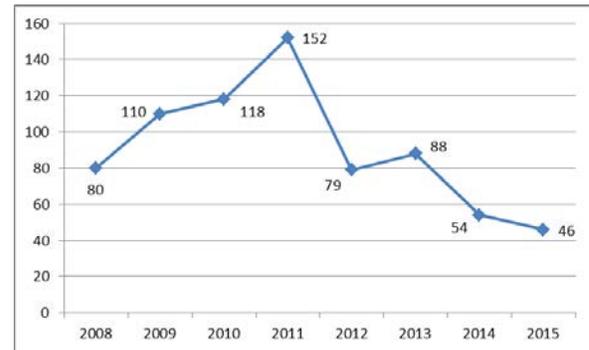


Number of contractors with CRF paid claims

Examining the number of contractors with an approved CRF claim provides additional perspective. One large contractor going out of business can lead to multiple CRF claims which are often pro-rated, distorting the average claim size. From FY 2007 to 2011, the number of contractors having at least one CRF paid claim filed against them increased from 80 in FY 2007 to 152 in FY 2011 (Figure 5). This trend of an increasing number of contractors having at least one

CRF paid claim filed against them reversed course in FY 2012 as a result of the housing slowdown, dropping to 79 claims by FY 2012; a 48 percent decline.

Figure 5: Annual number of contractors with at least one CRF paid claim

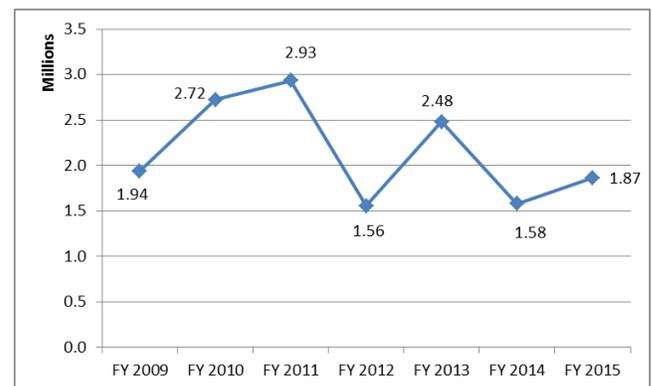


In FY 2015, the number of claims increased from FY 2014, but the number of contractors fell to 46 (Figure 5). Two contractors accounted for 23 claims.

CRF paid \$1.87M in claims in FY 2015

Both requested and approved amounts of payments made by the CRF since 1995 increased steadily until the downturn in the housing market occurred. After 2011, both requested amounts and payments began to moderate (Figure 6). FY 2015 payments increased by 18 percent during FY 2014.

Figure 6: Total payments to homeowners by fiscal year



In FY 2015, the average request for payment by homeowners was \$25,801

In FY 2015, the average requested CRF payment by a homeowner was \$25,801, a decrease of .1 percent. Average amounts requested by homeowners or lessees since CY 2008 are shown in Figure 7.

Figure 7: Average homeowner requested amount

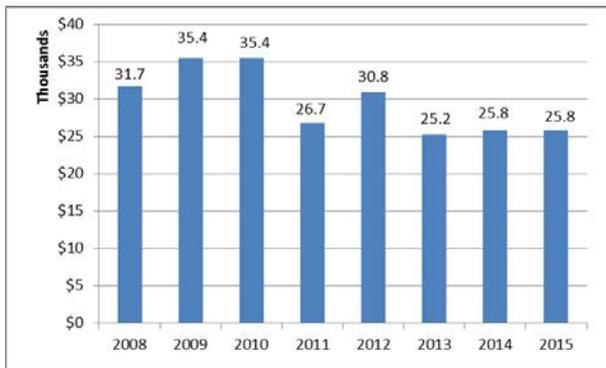
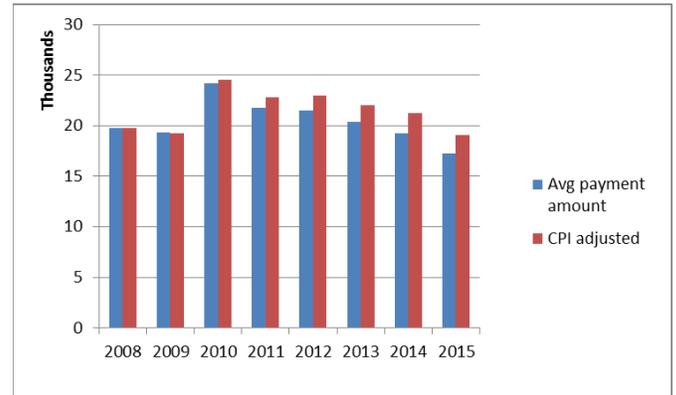


Figure 8 shows the CRF reimbursements to applicants for the past seven years in both consumer price index (CPI) adjusted and non-adjusted dollars by fiscal year. In FY 2011, the CRF began to see a decline in the size of claims. This may have been expected by the easing of pressures created by the late CY 2005 decline of housing starts (Figure 11).⁵

Both requested amounts and CRF reimbursements to consumers have trended downward since FY 2010, see Figures 7 and 8.

⁵ Residential builders make up the bulk of those against whom CRF claims are made at 97 percent; residential remodelers make up the remaining 3 percent. Residential builders, besides remodeling and contracted new home construction, often are involved in building on speculation, investing funds in home lots and participating in sub-developments. All of these activities were negatively affected by the housing bubble collapse, which often placed unsustainable pressures on residential contractors.

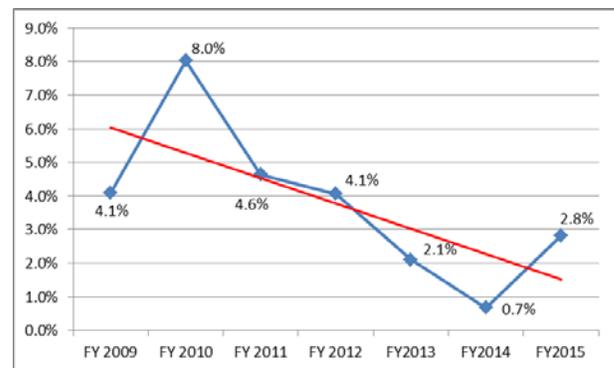
Figure 8: CRF average payment to homeowners or lessees



Operating costs of the CRF were 2.8 percent of revenues in FY 2015

Administrative expenses have continued to decline when measured as a percentage of fund revenue, averaging 6.6 percent annually for the past six years. Since FY 2009, operating costs measured as a percentage of revenues have declined

Figure 9: Operation costs as a percentage of CFR revenues



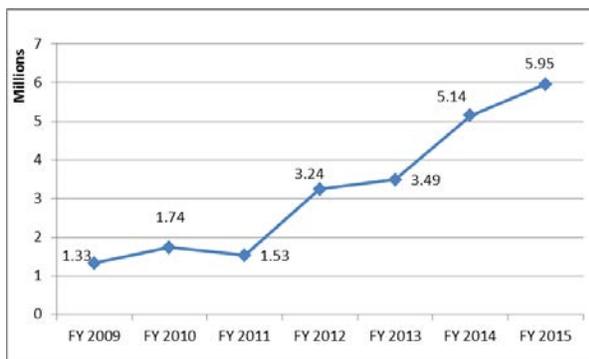
about 2 percent (see trend line in Figure 9). The peaks and valleys in Figure 9 are primarily a result of the fluctuating revenue cycle. In FY 2015, operating costs totaled \$77,745 or 2.8 percent of revenue.

CRF fund balance at the end of FY 2015 was \$5.95M

The fund’s fiscal health has improved in recent years. Lower administrative costs coupled with the financial reforms of 2010 have allowed fiscal balances to recover from the FY 2010 level.

The fund’s operating balance at the close of FY 2015 was \$5,952,408; a 16 percent increase from the FY 2014 balance. This increase is largely due to the cyclical nature of residential building licenses and declining payouts (see page 6).

Figure 10: Fund balance, FY 2009 to 2015



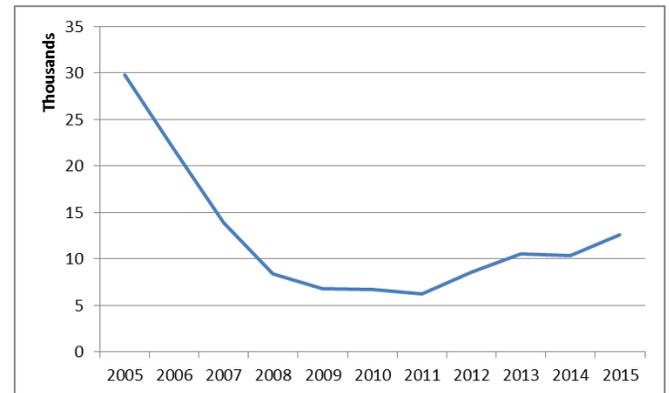
The 2006 housing crisis

The FY 2008 to FY 2015 period was heavily affected by the CY 2006 collapse of the Minnesota and U.S. real-estate market. The chart in Figure 11 illustrates the dramatic decline in construction of Minnesota single-family homes during the past 10 years. Note: The final three months of CY 2015 are projected.

The CRF claim payouts have an inherent time lag as the homeowner experiences loss, tries to resolve the issue on their own, goes to court, receives judgment, and then the CRF claims process begins. Meanwhile revenues are directly tied to the current

economic climate as contractors who go out of business do not renew licenses. This creates a disconnect between revenues and obligations in times of economic turmoil.

Figure 11: Minnesota housing starts, CY 2005 to 2015, St. Louis Federal Reserve⁶



Sales prices of homes also affect revenues, both by the amount of contractor sales of their services or properties, which determine license fees, and the size of homeowner claims filed with the CRF.

The average sales price of a new single-family home sold in June 2015 was \$229,200 in Minneapolis/St. Paul MSA. For comparison purposes, the average sales price was \$212,900 in June 2013 and \$171,800 in June 2012.⁷

From third quarter 2005 to third quarter 2013, the housing equity change is a loss of \$20,425.⁸ Housing activity as measured by building permit issuance plateaued in 2010 to 2011 after having shrunk 78 percent from

⁶ St. Louis Federal Reserve, Research, <https://research.stlouisfed.org/fred2/series/MNBP1FH>
⁷ <http://www.realtor.org/sites/default/files/reports/2015/embargoes/2015-q2-metro-home-prices/metro-home-prices-q2-2015-single-family-2015-08-11.pdf>
⁸ <http://www.prweb.com/releases/Minneapolis-home-value/market-changes/prweb11249672.htm>

2005 through 2009.⁹ Since the second quarter of 2014, Minneapolis MSA housing activity has risen 7.7 percent year to date.

In September 2015, the U.S. Department of Commerce measured national annual construction spending at a seasonally adjusted rate of \$1,094 billion, an increase of 14.1 percent from the previous year.¹⁰

Minnesota has seen rising home prices and declining foreclosure or short-sales, falling by half from June 2013 to June 2015.¹¹ Following the beginning of the market collapse in late CY 2005, CRF claims increased from FY 2007 through FY 2010. Average requested amounts from homeowners for compensation increased from FY 2007 through FY 2009, with only a small moderation in FY 2010. This was followed by a steep decline in FY 2011 and a moderate rise in FY 2012. FY 2013 saw a further 18 percent decline in average requested amounts from homeowners. Average requested amounts have remained flat through FY 2014 and FY 2015.

Home prices have steadily recovered from 2006 levels. As consumer confidence continues to rise, the effects on the CRF from the 2006 crisis should continue to decline, leading to more licensed residential contractors rejoining the market. Increasing building activity may increase future consumer reliance on the fund.

⁹ Metropolitan Council,
http://stats.metro.state.mn.us/stats/pdf/ResidentialConstruction_MS2010.pdf

¹⁰ U.S. Census Bureau News, U.S. Department of Commerce,
<http://www.census.gov/construction/c30/pdf/release.pdf>

¹¹ <http://www.builderonline.com/local-housing-data/minneapolis-st-paul-bloomington-mn-wi>

The future of the CRF

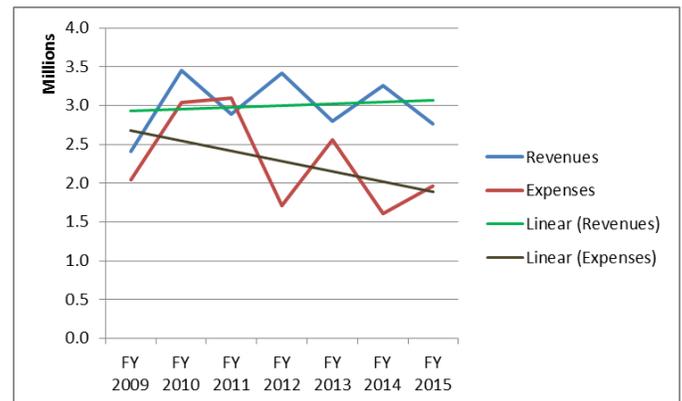
Declines in payouts to affected homeowners and declines in the average requested amounts by homeowners are likely to stabilize in the short term as building activity as remained relatively flat.

As the economic recovery continues in the Minnesota housing market and new contracting businesses emerge, claims against the fund may begin to rise moderately during the coming years. As consumer confidence continues to grow¹² in the post-recession period, both new and postponed construction and remodeling projects will begin, generating the potential for additional claims as the volume of activity increases.

As new contracting businesses are formed in response to increased demand, DLI will receive additional applications for licensures. Since the CRF recovery fund fee is collected at the time of contractor licensure, increased numbers of licensed contractors will lead to increased fund revenues. How this interplay of additional claims and increased revenue will affect the fund's fiscal health five years out is difficult to predict as the data DLI has analyzed is primarily post-recession.

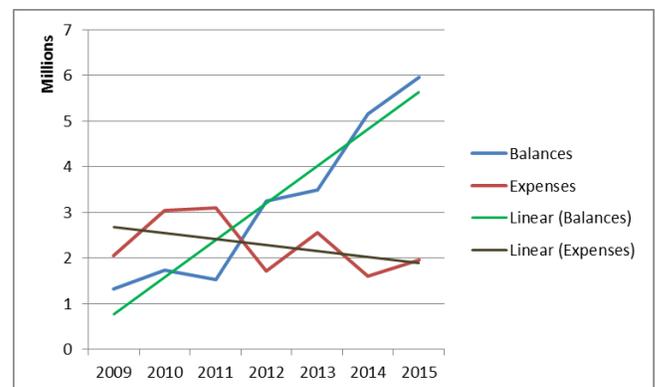
In the recent past, the surcharge placed on residential contractor licenses has led to increased revenues while payouts have continued to decline (Figure 12).

Figure 12: Revenues and payouts with trendlines, FY 2009 to 2015



This has led to increasing fund balances as payouts decrease and revenues increase.

Figure 13: Fund balances and payouts with trendlines, FY 2009 to 2015



This trend of an increasing gap between payouts and fund balances will be addressed by the reduction of \$80 in the assessment placed on the CRF fee that went into effect on July 1, 2015 (Figure 13).

¹² The Consumer Confidence Index (CCI) reached a low in August 2008 following the recession of 27. The most recent CCI (Oct 2015) is 90 on a scale of 100. <http://www.tradingeconomics.com/united-states/consumer-confidence>