# MINNESOTA CONTRACTOR RECOVERY FUND REPORT, 2012

MINNESOTA DEPARTMENT OF
LABOR & INDUSTRY
CONSTRUCTION CODES AND LICENSING



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# Executive Summary

The Contractor Recovery Fund's (CRF) operating balance for FY 2012 is \$3.2M. This was an increase of 111 percent from 2011's fiscal year balance of \$1.5M. This was largely due to an 18 percent increase in revenue because of the cyclical nature of residential building licenses and a 47 percent decrease in payouts in FY2012. A future downward adjustment in operating fund balances is to be expected as obligations (approved claim amounts not yet paid) have only declined 21 percent.

- In FY 2011 there were 135 claims against contractors filed involving 77 different contractors.
- In FY 2012 there were 110 claims filed against contractors involving 82 different contractors.
- In 2011, two contractors accounted for 39 of the claims filed or 29 percent of all filings and 13 percent of approved claims.
- In 2012, there was no significant concentration of payouts among contractors.
- Administrative expenses have declined from the FY 2010 high of 9.8 percent of revenue to 4.7 percent of revenue in FY 2012.
- Average CRF claim value increased from 2011's \$21,794 to \$46,738 in 2012. This rise in claim value is attributable to a very large number of small value cases in 2011, 63 percent of claims in 2011 were for less than \$10,000 compared to only 10 percent in 2012.

The housing crisis of 2006 continues to affect the Contractor Recovery Fund (CRF). The numbers of claims have fallen each of the last two years from the CY2010 high of 203 claims. The total dollars paid out in FY 2012, \$2.3M CPI adjusted, has also decreased since the FY2011 high of \$2.9M CPI adjusted. Revenues are increasing moderately while obligations are slowly declining. Short term projections are for these trends to continue.

# Figures



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# Contractor Recovery Fund, 1995-2012

## Introduction

The Minnesota Legislature created what is now known as the Contractor Recovery Fund (CRF) in 1974. Amendments to the program were made in 2000 and again in 2007. The current program is administered by the Minnesota Department of Labor and Industry (DLI) under Minnesota Statutes §326B.89 (Supp. 2011).

The fund 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 non-performance. Homeowners who suffer losses due to the actions of unlicensed subcontractors or material suppliers are not eligible for CRF reimbursement.

DLI administers the fund as part of its role in licensing residential building contractors, remodelers, roofers and manufactured home installers. 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. Certain standards of education and professional conduct are required to be maintained to obtain and maintain a license.

## Data

This report uses data provided by DLI's Construction Codes and Licensing Division, including the CRF administrator and the DLI Financial Services unit. In all cases, statistics were gathered by calendar years unless otherwise noted. As a general rule, revenue statistics are reported in fiscal years. With the inclusion of FY2012, the aggregate totals for all periods encompass six calendar years.

## Funding structure

The CRF is funded through the collection of fees from each licensed residential building contractor in Minnesota at the time of licensure or renewal. These fees are paid into the state treasury to fund the CRF. In 2012, the CRF fee collected for a two-year license, ranged from $470 to $670 depending upon the gross business receipts of the licensee[1]. The 2012 fee structure is shown in Table 1.

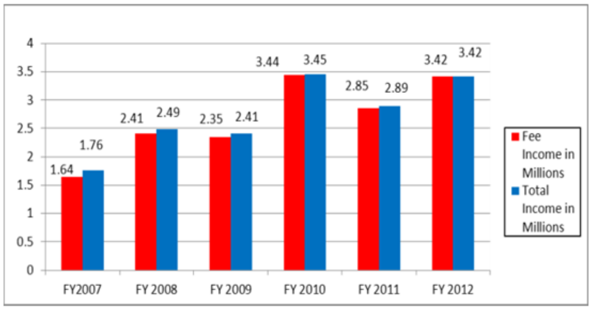
**Table 1: 2012 Residential contractor license fees.**

| Annual gross receipts | Contractor Recovery Fund fee |
|---|---|
| Less than $1 million | $470 |
| $1 million to $5 million | $570 |
| More than $5 million | $670 |

During fiscal years 2007 to 2012, more than 98 percent of the fund's revenues came from license fees. These other sources of revenue for the fund consist of interest earned and repayments collected from contractors. Contractor repayments to the CRF averaged $16,778 a year during the same period. These repayments were for the fund's claims payouts to homeowners or lessees, which were less than 0.2 percent of payouts.

[1] In 2001, the two-year licensure fee was $100, $150, and $200, dependent upon categorization as outlined in Table 1. A $150 surcharge was added in 2010.

**Figure 1: Contractor Recovery Fund revenues in millions, FY 2007 to 2012.**




Revenue generated from interest earned has averaged about 1 percent annually. CRF fees collected and total revenues during FY 2007 to 2012 are shown in Figure 1.

## Paying claims

From the collected fees from contractors, the CRF pays compensation to the homeowners or lessees who have sought and are eligible to receive compensation by statute (Minnesota Statutes §326B.89 (2010) and §326.975 (2006)). Homeowners and lessees must have obtained 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 prior to applying to the CRF for loss compensation. Once a homeowner or lessee's application for compensation is received and all supporting documentation is provided, DLI staff members carefully review the material. Then, based upon the CRF statute, DLI makes a determination of the compensable loss the homeowner or lessee suffered.

The CRF makes payments twice a year dependent upon when the originating incident occurred. Incidents or conduct of a licensed residential contractor that occurred previous to November 30, 2007, are treated differently than those claims which occurred after December1, 2007. Pre-2007 claims use the calendar year as a measure of time while post-2007 claims use the state fiscal year. When applying under the 2007 statute, the applicant must have their complete application with all the necessary supporting documentation submitted by Dec.1 in order to receive payment by July 15 of the following year. If the applicant is applying under a post-2007, they must have their completed application with all the supporting documentation submitted by June 1 in order to receive payment by the following Dec.1.

Until 2011, there were two ways an applicant could file a claim with the CRF. One was an accelerated procedure, which was available when the homeowner or lessee's claim for compensation was $7,500 or less and the contractor license set aside had not reached the $50,000 statutory limit[2]. The second was a standard procedure for compensation, for applicants who applied for more than $7,500 or who were otherwise not eligible to apply for compensation under the accelerated procedure. Since May 2011, the standard procedure is the only one available to consumers.

[2] Each licensed residential contractor had $50,000 of the CRF set aside to pay claims under the accelerated procedure. Once claims totaling $50,000 for each licensee had been made under the accelerated procedure, the homeowner must then use the standard procedure.

## Limitations on claims

**Table 2: Contractor Recovery Fund payments to homeowners or lessees, FY 1994 to 2012.**

| | 1994 to 2000 | 2001 to 2006 | 2007 to 2012 |
|---|---|---|---|
| Maximum homeowner or lessee claim per incident | $50,000 | $50,000 | $75,000 |
| Maximum CRF payout per contractor license | $50,000 | $75,000 | $150,000 |
| Maximum dollar amount per contractor set aside for the accelerated claim process | N/A | $15,000 | $50,000 |

Since 1994, the Legislature has increased the limitations of the amount of compensation a homeowner or lessee can recover from the CRF. As outlined in Table 2, there has been an increase in: the dollar amount applicants may seek in compensation, the upper limit on the amount CRF can pay in compensation for each contractor license, and the set asides for the accelerated claims process.

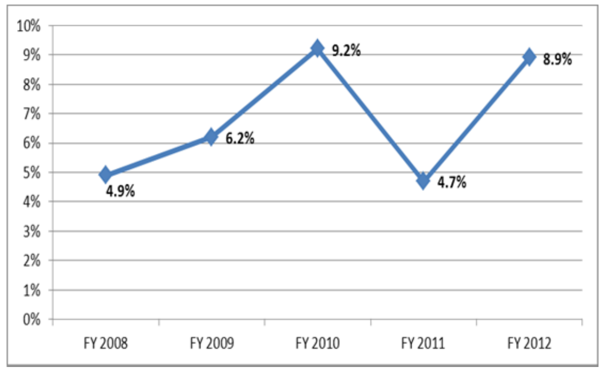
## Operating costs

Administrative operating costs have averaged 6.8 percent annually and are shown in Figure 2. Administrative operating costs are not available for FY 2007.

## Fund balances

Complicating the measurement of revenue streams is that obligations (i.e. that money approved for payment to consumers under the program) occur throughout the calendar year whereas payouts are only made once per year, leading inevitably to 2012 obligations being carried over to FY 2013.

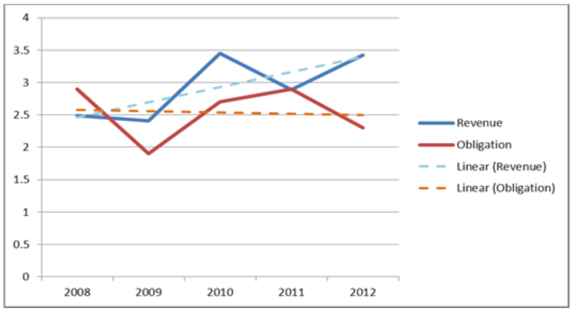
**Figure 2: Operation costs as a percentage of CFR payouts.**




The fund's operating balance for FY 2012 increased by 111 percent from FY 2011, $1.5M to $3.2M. This was largely due to an 18 percent increase in revenue because of the cyclical nature of residential building, (see page 11), licenses, and a 47 percent decrease in payouts in FY2012. Obligations have decreased by only 21 percent however, so a downward adjustment in the current operating fund balance is expected.

Administrative expenses have continued to decline when measured as a percentage of revenue. FY 2011 administrative and indirect expenses totaled $158,389 or 5.5 percent of revenue. FY 2012 administrative and indirect expenses totaled $159,306 or 4.7 percent of revenue. These are both significant reductions from the FY2010 total of $320,678 or 9.3 percent of revenue.

**Figure 3: Obligations and Revenues 2008-2012 with Projections.**

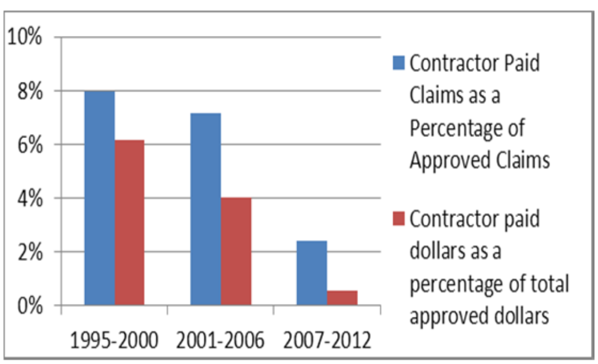



## Three period comparisons: 1995 to 2000, 2001 to 2006, and 2007 to 2012

### Contractor payments of CRF claims have declined

When the CRF processes a claim for compensation, it notifies the contractor in order to allow the contractor an opportunity

**Figure 4: Number of contractor paid or reimbursed claims as a percentage of total approved claims contrasted with the total contractor paid dollars as a percentage of total approved dollars.**

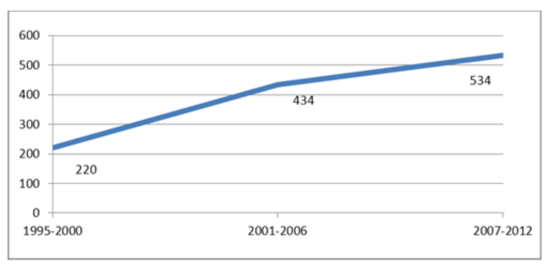



to pay the claim. Contractor paid claims fall into one of two categories, either the contractor reimburses the CRF for the amount paid or the contractor directly pays the court-ordered judgment after the claim is filed with the CRF[3].

Between the periods 1995 and 2012, there has been a dramatic decline in the percentage of claims paid by contractors. In the 1995 to 2000 period, 8 percent of all claims were paid by contractors. In the 2001 to 2006 period, 7.2 percent of all claims were paid by contractors. By the 2007 to 2012 period, that percentage had fallen to 2.4 percent. Additionally, the average size of the contractor payment made was $6,259 (6.2 percent of total approved dollars in the 1995-2000 period) which decreased to $3,847 (0.5 percent of total approved dollars) in the 2007 to 2012 period.

In summary, during the period studied, fewer claims are being satisfied directly by contractors and the size of the payments made by contractors has declined (see Figure 4). At the same time, the number of contractors having claims filed against them with the CRF increased from 220 in the 1995 to 2000 period to 434 in the 2001 to 2006 period and 534 during the 2007 to 2012 period (*see Figure 5).*

**Figure 5: Total number of contractors with CRF claims filed by homeowners or lessees.**



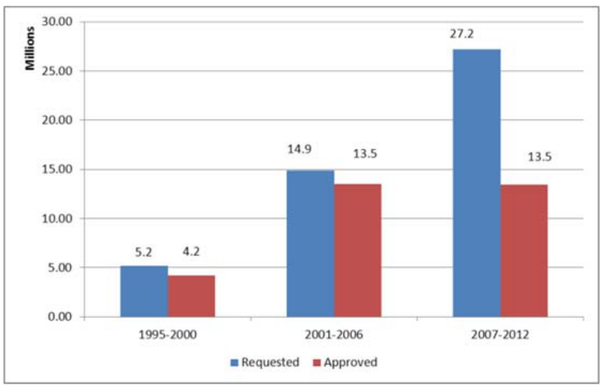

[3] Statutory incentive for the contractor to pay the claim is provided by Minnesota Statutes §326B.84 (19) (2010). That statute allows DLI to take enforcement action against a contractor's license if the licensee engages in any act or practice that results in compensation paid to a homeowner/lessee from the CRF.

[4] One 1998 dollar, adjusted by the Consumer Price Index (CPI) (the midpoints of the ranges) is $1.16 for 2004 and $1.32 for 2009.

**Both the quantity of CRF claims and the total dollars claimed have increased**

Since the 1995 to 2000 period, the total annual number of claims has increased from 81 claims annually to 177 in 2001 to 2006 and 158 claims in 2007 to 2012. Between the periods 1995 to 2000 and 2007 to 2012, the average requested claim amount has increased from $11,043 to a requested claim of $31,082, a 181 percent increase[4]. The average approved amount of claims has kept pace with this increased requested claim amount, growing from $6,837 in 1995 to

**Figure 6: Total approved claim dollars in millions adjusted for inflation for the three periods.**




$19,136 in 2007, a similar 180 percent increase. The total amounts paid out by the CRF are not available prior to 2007, hence the reliance on approved amounts in this study. However, by using the CRF approved amounts adjusted for inflation[5] during the three periods of the CRF, the approved amounts have remained fairly steady for the latter two periods (s*ee Figure 6*).

**Contractor license limit payouts decline**

The Minnesota Legislature has set a limit on the amount of compensation that can be paid by the CRF for judgments against each individual contractor (Table 2). Claims which have been filed against licensed contractors where this "contractor license limit" ($75,000 in 2001 to 2006, $150,000 in 2007 to 2011) was reached, decreased from 38.3 percent of claims in 2001 to 2006 to 10.1 percent of claims in 2007 to 2012. It is to be expected the current period's percentage of claims denied due to the upper contractor license limit being reached will rise slightly due to the inherent time lag of the system, yet it may be difficult to reach the 2001 to 2006 level of 38 percent. In 2012, only three applications were made for reimbursement that exceeded the $150,000 limit and the average requested reimbursement amount was $46,738.

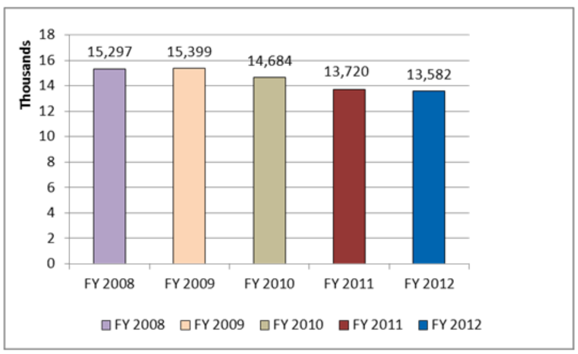
Pressures on the CRF are the result of three factors: the number of approved claims against the fund, the average amount of those claims, and the revenues generated by license fees. The percentage of homeowner or lessee claims being denied due to reaching the upper contractor license limit is one measure of the consumer protection function which the CRF affords. It is not clear whether increasing the contractor license limit has a similar long-term effect, as for example adding interstate lanes for traffic (increased number of lanes leads to increased traffic volumes), where the number of claims against individual contractors simply increase to match the new claim limits. However, the early evidence does not support this hypothesis. Claims denied due to reaching the upper contractor license limit declined from 13.9 percent of total cases in the 1995 to 2000 period to 4.7 percent in the 2007 to 2012 period. Although the numbers of claims were smaller, there were no denials due to licensure limits in FY 2011 or FY 2012.

[5] Figure 5 adjusts approved dollars for the CPI by the mid-year point of the three periods.

## The 2007 to 2012 years

The 2007 to 2012 period was heavily affected by the post-2005 collapse of the real-estate market across the nation. Minnesota was not exempted from the housing bubble and its impacts are shown in the following pages. Calendar year 2012 continues the trend begun in 2011, where the total number of claims is markedly lower compared to the preceding two years. As

**Figure 7: Number of licensed residential builders in Minnesota.**




seen in Figure 7, Minnesota has experienced an 11 percent decline in the number of licensed residential contractors since 2008. Minnesota also experienced significant 38 percent decline between 2010 and 2011 in the average requested amount of compensation by homeowners or lessees (*see Figure 8*).

CRF staff members attribute the decline in size of claims to an increase in the number of claims in 2011 where down payments were accepted, but the work was not performed by the contractor. Accelerated claims in 2011, when compared to 2010, rose from 5 percent of total cases to 60 percent (accelerated claims are smaller statutorily).

**Figure 8: Requested CRF claim amount, CY 2007-2012.**

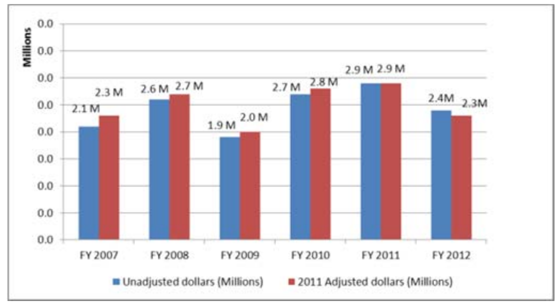
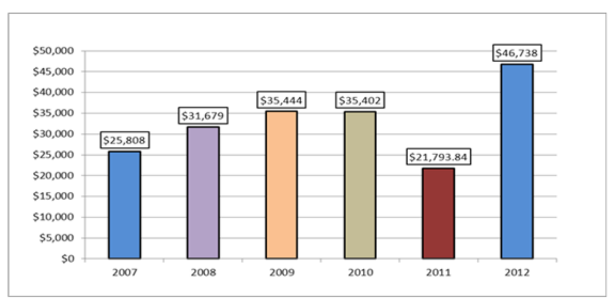



Figure 8 shows CRF payouts by fiscal years, in both CPI adjusted and unadjusted dollars.

Average amounts paid to homeowners or lessees in **adjusted** dollars by calendar year are shown in Figure 9. The 2012 steep rise seen in Figure 9 is also related to the abundance of smaller claim cases in 2011, (81 of 128 cases in 2011 less than $10,000 compared to 11 of 110 in 2012).

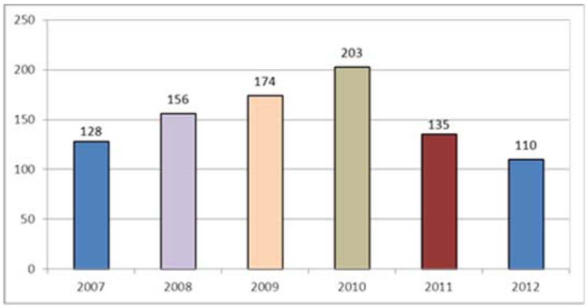
The number of claims against residential builders in the CRF has also declined from an average of 165 in the preceding four calendar years to 135 in 2011 and 110 in 2012 *(see Figure 10).*

**Figure 9: Contractor Recovery Fund average payment to homeowners or lessees, FY 2007 to 2012.**




Claims where the residential builder's upper license limit was reached have declined yearly, from 30.5 percent in 2007, to 14.7 percent in 2008. There have been no license

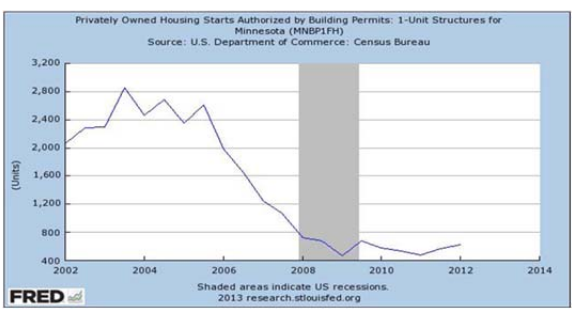
**Figure 10: Annual number of CRF claims, 2007 through December 2012.**




limit denials in since CY2009. There has been a steady growth in the total number of cases throughout the period until 2010.

In 2011, the CRF began to see a decline in **t**he size of claims, as illustrated in Figure 8. This may have been expected by the pressures created by the late 2005 decline of housing values[6] (*see Figure 11*).

**Figure 11: MN Housing Starts, 2002-2012, Federal Reserve, St. Louis.**




Cases where contractors have paid the claim have continued to decline during the 2007 to 2012 period with a high of seven paid claims in 2008, declining to two paid claims in 2009 and 2010, one paid claim in 2011, and rising again to five paid claims in 2012. Total dollars paid by contractors with claims filed against them using the CRF have been below 1.3 percent of approved payouts annually the past four years.

It is important to emphasize the effect the housing value decline had on the CRF. The chart[7] in Figure 10 illustrates the dramatic decline in construction of Minnesota single family homes during the CRF's history. The CRF claim payouts have an inherent time lag (homeowner experiences loss, tries to resolve the issue themselves, goes to court, receives judgment, and then the CRF claims process begins) while revenues are much more directly tied to the current economic climate (contractors who go out of business do not renew licenses) creating a disconnect between revenues and obligations in times of economic turmoil.

The average sales price of a new single-family home sold in 2010 was $272,900. For comparison purposes, the average sales price[8] was $270,900 in 2009, $292,600 in 2008 and $313,600 in 2007. The seven year housing equity change is a loss of $51,500[9]. This decline in housing values would influence the average requested amount from CRF, since the higher the home's cost the higher the potential loss. Housing activity as measured by building permit issuance plateaued in 2010 after having

[6] 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, placing often unsustainable pressures on residential contractors.

[7] St. Louis Federal Reserve, Research, http://reserch.stlouisfed.org/fred2/graph/?chart_tyoe=bar&s[1][id]=MNBPIFH

[8] "Twin Cities Residential Construction: Glimmers of Hope in 2010," Metro Stats, Baris Gumus-Dawes and Libby Starling, Metropolitan Council Research, http://stats.metc.state.mn.us/stats/pdf/ResidentialConstruction_MS2010.pdf

[9] U.S. Census Bureau, http://www.census.gov/construction/chars/highlights.html.

shrunk 74 percent, from 7.3 per thousand residents to 1.9 per thousand residents, between 2005 and 2009.[10]

Recently, DLI has seen increasing home prices, 13.2 percent year-to-date increases for Minneapolis, and declining foreclosure/short sales, roughly half the U.S. national average. Following the beginning of the market collapse in late 2005, DLI saw increasing CRF claims from 2007 through calendar year 2010, increasing average requested amounts from homeowners for compensation from 2007 to 2009 with only a small moderation in 2010 followed by a steep decline in 2011 and a sharp rise in 2012. A steady decline in the number of residential builder licenses issued throughout the 2007 to 2012 period follows the collapse.

## Comparisons between 2011 and 2012

The number of claims against contractors through the CRF decreased from 128 in 2011 to 110 in 2012. Not surprisingly, with the abolition of accelerated cases in May, 2011, the number of accelerated cases declined from 77 to 46.

The number of contractors involved in the CRF process increased from 67 in 2011 to 82 in 2012 yet far below the 2010 high of 152. Claims for each contractor declined from 1.91 in 2011 to 1.34 in 2012.

Cases where the contractors settled their claims with the claimants or repaid the fund increased from one to five, yet the total amount repaid remained small, $28,517 of the $2.36 million paid out by the fund or 1.2 percent.

CRF revenues are shown in Figure 12. The revenues (almost entirely licensure fees) show a two-year cycle of revenue increases and decreases occurring due to the greater number of license renewals in the even-numbered years.

Four factors are responsible for the decline of revenues between FY 2010 and FY 2011:

1) the number of residential builders declined by 6.5 percent in FY 2011, followed by a further decline of 1 percent in FY 2012.

2) the CRF portion of the license fees is determined by the gross annual receipts of the residential builder during the previous year and as residential builders' annual receipts decline, so does the licensing fee collected under the CRF program**,** see Table 1 and;

3) the FY 2010 bump in receipts is also affected by the $150 surcharge ($75 annually) on two-year license renewals imposed by DLI pursuant to Minnesota Statutes §326B.89, subd. 16 (2010).

4) beginning January 1, 2010, licenses were renewed for two years and no longer annually.

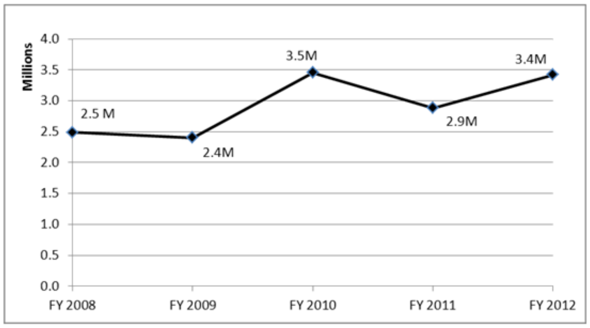
The bulk of revenues to the CRF are realized January through March during the residential contractor renewal period.

Roughly a two-year time lag occurs from the time homeowners or lessees of Minnesota residential property have experienced a

[10] National Association of Realtors, http://www.realtor.org/sites/default/files/reports/2012/local-market-reports-2012-q3/local-market-reports-2012-q3-mn-minneapolis.pdf

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 claim with the CRF. The majority of this time is spent in obtaining a

Figure 12: CRF revenues in millions, FY 2008 to 2012.




district court-ordered judgment. Because of this time lag, the CRF's obligations are experiencing the effects of what occurred in the housing market two years previously in 2009 and 2010 (*see Figure 11*).

As a result, the amounts of payouts are likely to stay fairly consistent in the next two years, *(see Figure 3)*, mirroring the housing market.

## Conclusion

The housing crisis of 2006 continues to affect the Contractor Recovery Fund. Some small reductions in aggregate payouts should continue to be realized with the housing market stabilization over the past two years.

CRF revenues, on the other hand, are much more responsive to market demand for housing stock. As demand has decreased, fewer residential builders have acquired licenses, decreasing the CRF revenues available to pay claims in the recent past. Increasing housing demand coupled with the overall reduction of foreclosure/short sale stock should increase revenues slowly over the coming years as housing demands increase and foreclosure stock decreases.

Residential housing start data in Minnesota has been promising year to date. In the short term, revenues should either hold steady or decrease slightly in SFY2013 due to the two year cycle factor of license renewals. Increased building activity may lead to some increase in licensures for residential builders and this may be enough to offset the effects of the odd-year revenue cycle. The fund's healthier balance sheet as well as the predicted declining outlays will mitigate any 2013 revenue shortfalls.

The fund's fiscal health has improved over the course of the last year. Over the longer term, revenues are increasing moderately while obligations are slowly declining. Current projections are for these trends to continue.