

MINNESOTA CONTRACTOR RECOVERY FUND REPORT, 2014



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Minnesota Contractor Recovery Fund Report, FY 2014

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Executive Summary

Contractor Recovery Fund (CRF) payouts decreased from \$2.48 million in FY 2013 to \$1.58 million in FY 2014, a 36 percent reduction.

CRF revenues increased from \$2.8 million in fiscal year (FY) 2013 to \$3.26 million in FY 2014, an increase of 16.4 percent, due to the two-year cyclical nature of residential building licenses.

The CRF operating balance as of FY 2014 is \$5.14 million, an increase of 47 percent from the 2013 fiscal year balance of \$3.49 million. The increase in the operating balance is due to a 36 percent decrease in payouts and the increase in revenues driven by the two-year cycle of license renewals.

- In FY 2014, 83 claims were filed against contractors, involving 54 different contractors. Four cases were resolved by the contractor settling directly with the claimant. Two cases were denied. One case was incompletely filed and returned to the claimant. One case was withdrawn, leaving 75 claims paid by the CRF. The total amount of claims paid by the CRF was \$2.48 million and total amount of claims resolved by CRF was \$2.69 million.
- In FY 2014, one contractor accounted for 15 of 17 CRF payouts that involved multiple claims against a contractor. The claims totaled \$45,856, yet

accounted for only 3 percent of the FY 2014 CRF payouts.

- The average CRF requested claim amount decreased from \$30,838 in FY 2013 to \$25,827 in FY 2014.
- In FY 2014, administrative expenses continued to decline when measured as a percentage of revenue to 6.5 percent. Since FY 2009, administrative and indirect expenses measured as a percentage of revenues declined about 1 percent.

The CRF was strongly affected by the calendar year (CY) 2006 housing crisis and those effects continue today. The number of claims fell from the FY 2011 high of 203 claims to FY 2014's 82. The total amount paid out in FY 2014, \$1.58 million, is 46 percent below the FY 2011 total of \$2.93 million.

CRF revenues are more responsive to the market demand for housing stock. As market demand decreases, fewer residential builders acquire licenses. In FY 2014, the number of contractor licenses acquired declined by 7.9 percent. Fewer licensures acted to decrease FY 2014 revenues (when compared to the past two-year cycle year FY 2012) by 4.7 percent. Increased housing demand, coupled with the overall reduction of foreclosure or short sale stock, should increase revenues and claims slowly 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 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 nonperformance. 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. 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. There are currently 12,511 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 provided by 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 calendar year (CY) 2013, prior to the start of the new fiscal year, will not be paid until FY 2014.

Beginning in this year's 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.

One claim was determined to be an outlier. The claim received was for 20 times the licensure limit and this claim was excluded from this study's calculations.

Fee revenues to the CRF were \$3.26M in FY 2014

During FY 2008 to 2014, 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 0.6 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 FY 2014, 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 2014 fee structure is shown in Table 1 and includes a \$150 surcharge to the recovery fund added in CY 2010.

Table 1: FY 2014 residential contractor license fees

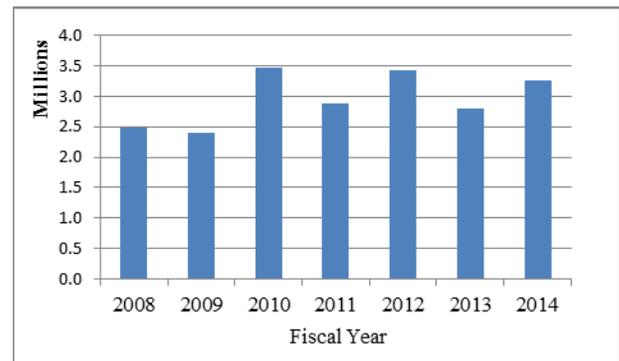
	Tier 1 Contractors (Less than \$1 million in annual sales)	Tier 2 Contractors (\$1 million to 5 million in annual sales)	Tier 3 Contractors (Over 5 million in annual sales)
License	\$220	\$220	\$220
Recovery Fund	\$320	\$420	\$520
Recovery Fund Surcharge	\$150	\$150	\$150
TOTAL	\$690	\$790	\$890

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

¹ 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 2008 to FY 2014 are shown in Figure 1. Interest earned income does not have much of an effect on the fund’s health.

Figure 1: CRF revenues in millions, FY 2008 to FY 2014

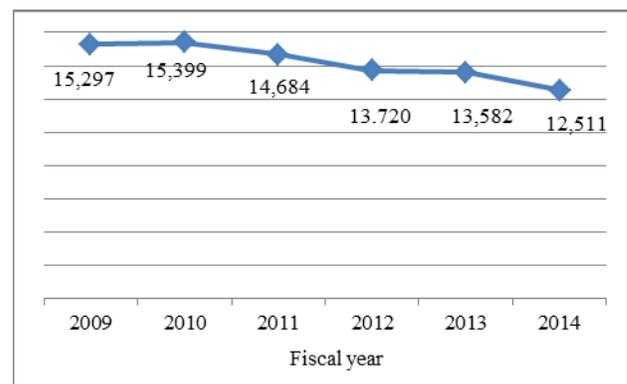


Since the CRF funds are collected with the license fees, the fund’s revenues are subject to the two-year licensure cycle. This effect is clearly shown in Figure 1 with revenues decreasing in odd number years by an average of 17 percent.

Four factors affect CRF revenues:

- 1) The decline of the number of residential builders has continued since the 2006 housing crisis, declining 7.8 percent in FY 2014 and 18.2 percent when measured from FY 2009.

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 fluctuations in revenue.

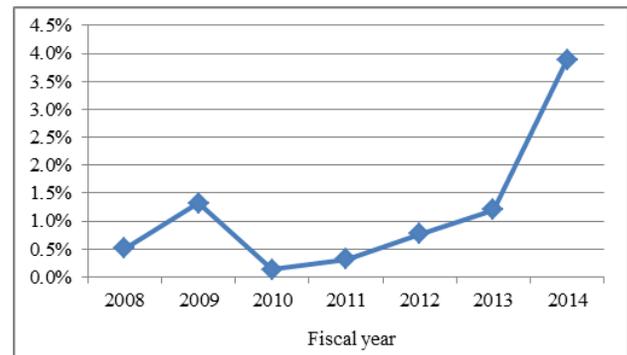
Revenues from contractor reimbursements to the CRF continue to rise in FY 2014

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

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 2014



CRF paid claims averaged 0.5 percent. Beginning in FY 2013, that percentage rose to 1.2 percent in FY 2013 and 3.9 percent in FY 2014. Similarly, total contractor reimbursements during the FY 2008 through the FY 2012 period were \$11,803. Payments increased to \$29,893 in FY 2013 and \$61,552 in FY 2014.

Claim payments

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 to apply to the CRF for loss compensation. Typically, there is a two-year time 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 claim with the CRF. 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 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.

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). Before applying for 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 a contract with the licensed contractor.

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.

Until 2011, there were two ways for an applicant to file a claim with the CRF, a standard procedure and an accelerated procedure. Under the accelerated procedure, payments were made as the claim was approved for payment. In FY 2014, only the standard procedure is available to applicants and the final payments under the old accelerated procedure were made in FY 2010.

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 pro-rates homeowners’ claims.³

Table 2: Contractor Recovery Fund limits for payments to homeowners or lessees, FY 2008 to FY 2014

	FY 2008 to FY 2014	FY 2001 to FY 2007
Maximum homeowner or lessee claim per incident	\$75,000	\$50,000
Maximum CRF payout per contractor license	\$150,000	\$75,000
Maximum dollar amount per contractor set aside for the accelerated claim process ⁴	\$50,000	\$15,000

In FY 2014, there were five prorated claims due to the contractor limit being reached. All of these pro-rated claims involved one contractor, amounting to 6.1 percent of all claims. An additional two applications were

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

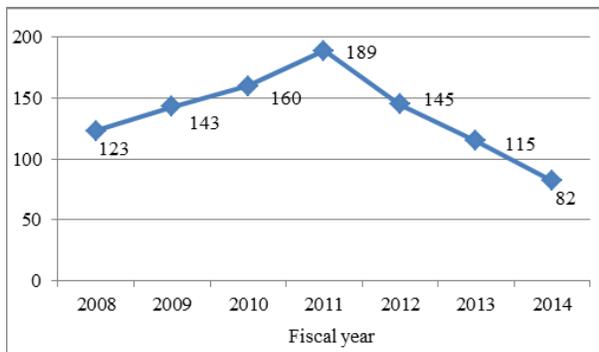
⁴ The last payments under the accelerated process were made in FY 2010

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

Number of requested claims in FY 2014 was 82

From FY 2008 to FY 2011, the number of complete claims received increased and peaked 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 (Figure 4). Considering the two-year time lag for claims as discussed on page 3, the number of FY 2014 claims fell below that of FY 2008, when the housing crisis began, by 33 percent.

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

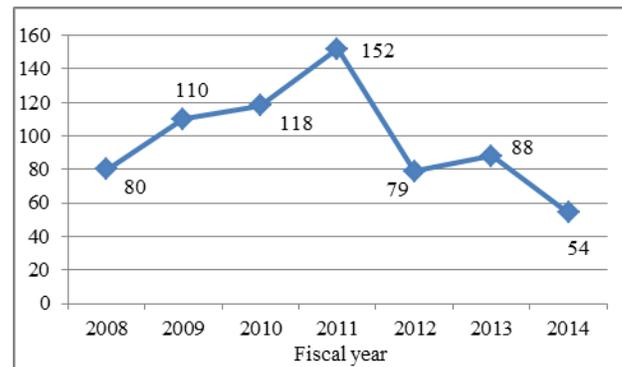


Number of contractors with CRF paid claims

Looking at the number of contractors with at least one CRF paid claim, as opposed to the total number of complete claims, can limit the effect of either a single large or multiple smaller contractors going out of business and 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, falling to 79 claims for FY 2012; a 48 percent decline.

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

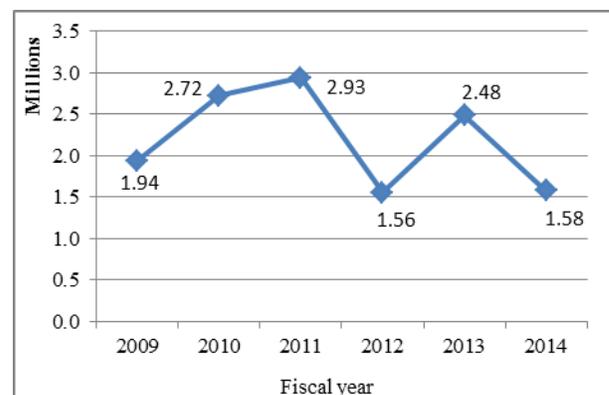


In FY 2014, the downward trend of contractors with a CRF paid claim continued, falling 39 percent to 54 contractors with 82 CRF paid claims (Figure 5).

CRF paid \$1.58M in claims in FY 2014

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).

Figure 6: Total payments to homeowners by fiscal year



In 2014, the average payment to homeowners was \$25,827

In FY 2014, the average CRF payment to a homeowner was \$25,827, an increase of 11 percent. Average amounts paid to homeowners or lessees in CY 2007 in consumer price index (CPI) adjusted and non-adjusted dollars by fiscal year are shown in Figure 7. It is illustrative to compare Figure 11 (Minnesota housing starts) with figure 7 as it reflects the trend of Minnesota housing starts.

Figure 7: CRF average payment to homeowners or lessees, FY 2008 to 2014

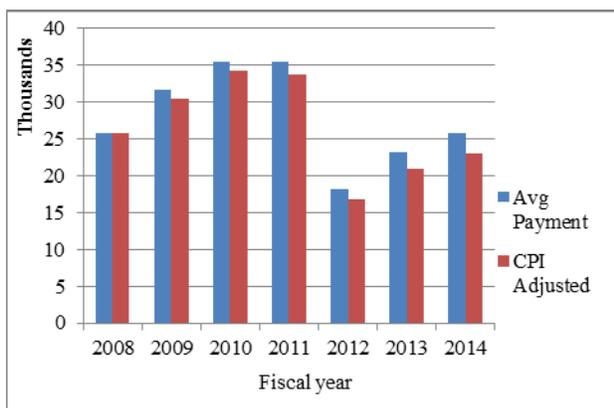
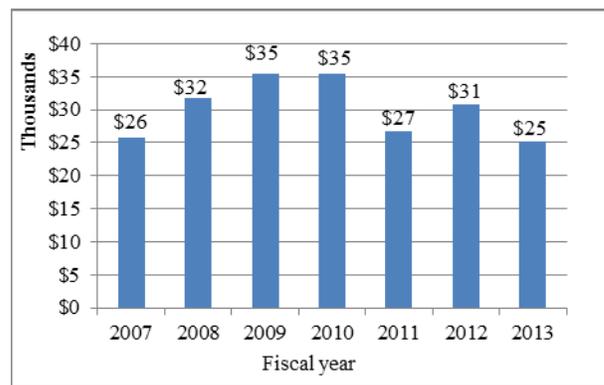


Figure 8 shows the CRF reimbursement requests by applicants for the past seven years. In FY 2011, the CRF began to see a decline in the size of claims, as illustrated in Figure 8. This may have been expected by the easing of pressures created by the late CY 2005 decline of housing starts (Figure 11).⁵

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: Average homeowner requested amount

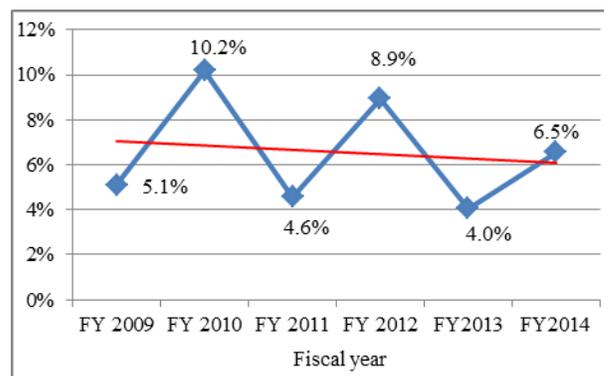


Since FY 2013, more claims are being satisfied directly by contractors and the size of those payments made by contractors has increased (Figure 3).

Operating costs of the CRF were 6.5% of revenues in FY 2014

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, administrative and indirect expenses measured as a percentage of revenues have

Figure 9: Operation costs as a percentage of CFR revenues



declined about 1 percent (a trend line has been added to Figure 9 to illustrate). The peaks and valleys in Figure 9 are primarily a result of the fluctuating revenue cycle. In FY

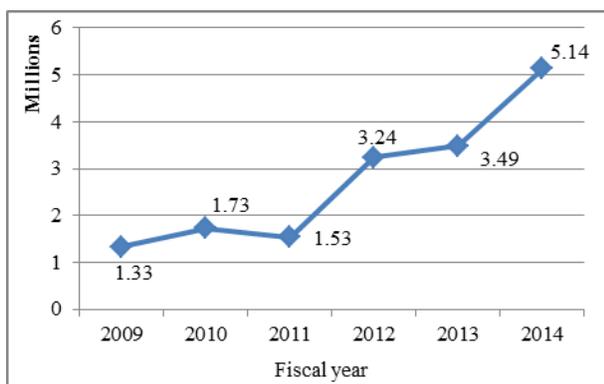
2014, administrative expenses totaled \$103,496 or 6.5 percent of revenue.

CRF fund balance at the end of FY 2014 was \$5,144,807

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 2014 was \$5,144,807. This is an increase of 47 percent from the FY 2013 balance of \$3,491,278. This increase is largely due to the cyclical nature of residential building licenses (see page 11) and declining payouts as discussed on page 6.

Figure 10: Fund balance, FY 2009 to 2014

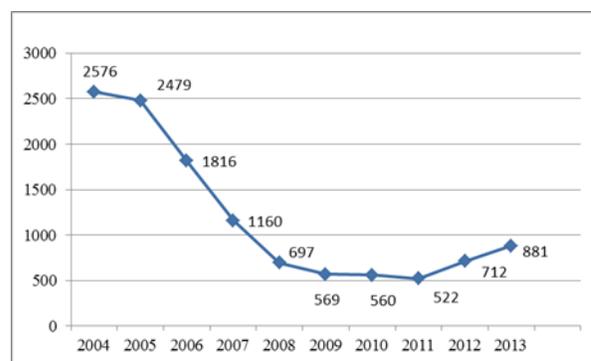


The 2006 housing crisis

The FY 2008 to FY 2014 period was heavily affected by the CY 2006 collapse of the national real-estate market. Minnesota was not exempt from the housing bubble. The chart in Figure 11 illustrates the dramatic decline in construction of Minnesota single-family homes during the past ten years.

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 2004 to 2013, 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 the third quarter of CY 2013 in Minneapolis/St. Paul MSA, was \$240,569. For comparison purposes, the average sales price was \$221,752 in CY 2012 and \$202,485 in CY 2011.⁷

⁶ St. Louis Federal Reserve, Research, [http://research.stlouisfed.org/fred2/graph/?chart_tyoe=bar&s\[1\]\[id\]=MNBPIFH](http://research.stlouisfed.org/fred2/graph/?chart_tyoe=bar&s[1][id]=MNBPIFH)

⁷ www.builderonline.com/local-housing-data/plains/minneapolis-st-paul-bloomington-mn-wi/pricing.aspx

The nine-year housing equity change is a loss of \$26,700.⁸ This decline in housing values would influence the average requested amount from CRF because the higher the home's cost the higher the potential loss. Housing activity as measured by building permit issuance plateaued in 2010 to 2011 after having shrunk 78 percent from 2005 through 2009.⁹ Since 2011, Minnesota housing activity has risen 25 percent, annually averaged.

In October 2014, the U.S. Department of Commerce measured national annual construction spending at a seasonally adjusted rate of \$971 billion, an increase of 3.3 percent over the previous year.¹⁰

Recently, Minnesota has seen rising home prices, a 10.2 percent year-to-date increase for Minneapolis, and declining foreclosure or short sales, roughly half the U.S. national average. 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 decline in average requested amounts from homeowners of 18 percent.

Home prices have recovered to 2006 levels for the most part. As consumer confidence continues to rise, the effects on the CRF of

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 if another market correction occurs.

⁸ National Association of Realtors, www.realtor.org/sites/default/files/reports/2012/local-market-reports-2012-q3/local-market-reports-2012-q3-mn-minneapolis.pdf

⁹ Metropolitan Council, http://stats.metc.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>

The future

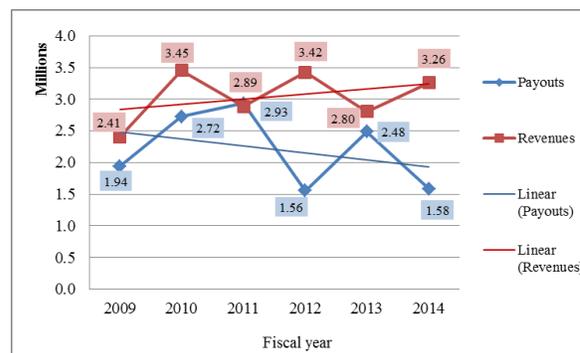
Declines in payouts to affected homeowners and declines in the average requested amounts by homeowners are likely to stabilize in the short term.

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 grow¹¹ in the post-recession period, both new and postponed construction and remodeling projects will begin, generating 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.

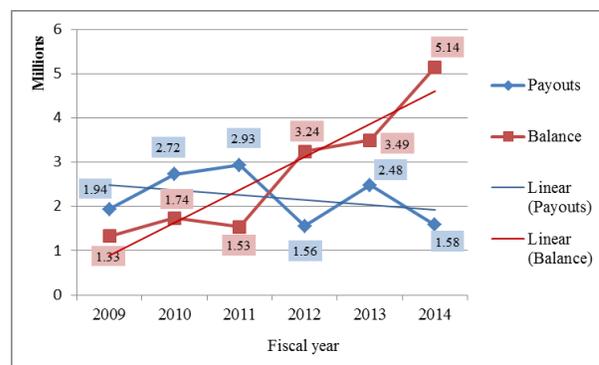
In the recent past, the surcharge placed on residential contractor licenses has led to increased revenues while payouts have continued to decline (Figure 12).

Figure 12: Revenues and payouts with trendlines, FY 2009 to 2014



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

Figure 13: Fund balances and payouts with trendlines, FY 2009 to 2014



This trend (Figure 13) of an increasing gap between payouts and fund balances can be addressed by a reduction in the \$150 assessment placed on the residential contractor licenses in 2010.

¹¹ The Consumer Confidence Index (CCI) reached a low in August 2008 following the recession of 27. The most recent CCI is 88.7 on a scale of 100. www.conference-board.org/data/consumerconfidence.cfm