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SEPTEMBER 2023

Brick by Brick

Methods of Stabilizing Utah's Construction Sector

–BRICK BY BRICK–

METHODS OF STABILIZING UTAH'S CONSTRUCTION SECTOR

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Research Report 813

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A special thank you to KUER and Brian Albers for the photos found on pages 9, 17, 18, 19, and 21.

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INTRODUCTION

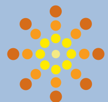
The construction and construction materials supply industries both play a substantial role in Utah's economy with the latter specifically being composed of 345 firms and employing roughly 4,569 people in the state. The industry in Utah has recently grown to a market size in excess of $2 billion constituting just over 1% of the state's GDP.[1] This supports the overall construction industry which makes up 7% of the state's economy.

In light of the importance of the construction materials supply industry and its impact upon construction and the overall economy, the Utah Foundation undertook a study to examine the industry in the face of an expiring program used to stabilize it. The study therefore also examines Utah and other states' approaches to state-run insurance funds, construction registries, bond requirements, private insurance, and trust fund statutes.

This report first briefly highlights global and national trends in the construction and construction materials supply industries – particularly drivers such as infrastructure demands and the homebuilding industry. The Utah Foundation then briefly addresses national and local housing markets as well as financial market realities likely to impact the construction materials supply industry in Utah. The heart of the report addresses legislative changes that have altered how unpaid debts among construction materials suppliers, subcontractors, and general contractors are resolved within the industry. Finally, the Utah Foundation highlights how other states address these issues and the benefits and drawbacks of the various methods.

This report was funded by the Utah Construction Suppliers Association with added support from: Sunpro, Geneva Rock, Burton Lumber, LKL Associates, Plastic Specialties, Inc., Staker Parson Companies, Builders FirstSource, and the Utah Plumbing & Heating Contractors Association.

KEY FINDINGS OF THIS REPORT

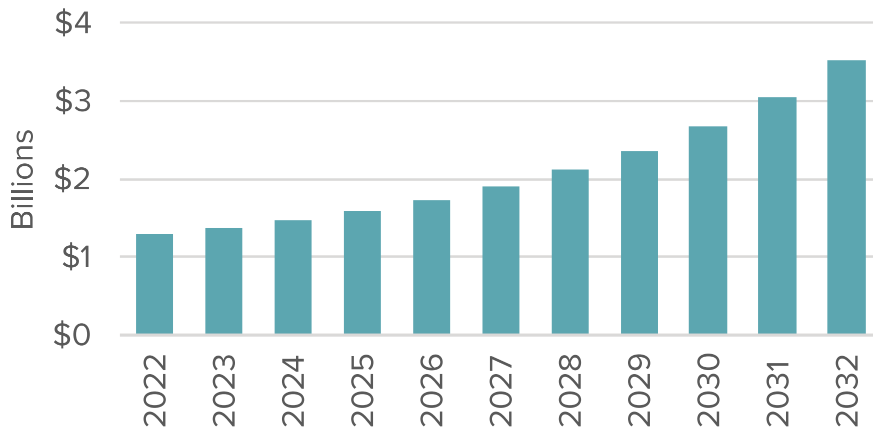


- The elimination of lien rights without an option being employed to protect actors in the construction industry from non-payment may inject friction into the construction industry when the state can least afford it. (See page 4.)
- Construction lien rights are currently under threat in Utah. (See page 7.)
- Utah's Residence Lien Recovery Fund's defunding may have been premature given subsequent trends in claims. (See page 9.)
- A significant portion of Utah's construction industry is supported by short-term credit provided by construction suppliers. (See page 11.)

1 *Lumber and Building Material Stores Industry in the U.S.: Market Research Report*, April 20, 2023, https://www.ibisworld.com/us/industry/utah/lumber-building-material-stores/40560/.

The global construction materials market is projected to expand through the next decade.

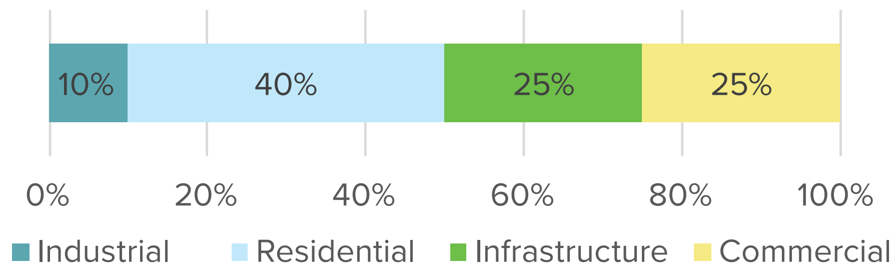
Figure 1: Construction Materials Market Size Projections, 2022-2032 projected



Source: Precedence Research

The construction supplies industry is more than just residential and commercial.

Figure 2: Global Construction Materials Market Share, by End-User, 2022



Source: Fortune Business Insights

THE CONSTRUCTION AND CONSTRUCTION MATERIALS SUPPLY INDUSTRIES: GLOBAL AND NATIONAL TRENDS

The global construction materials market is projected to expand through the next decade (See Figure 1.) While some of this nominal change is certainly driven by current and anticipated inflation, over time there are also likely to be other drivers of price changes, including ongoing global economic growth, population growth increasing the demand for housing, and perhaps an increased scarcity of materials.

Of course, in spite of the global significance of residential demand for construction materials, the industry obviously provides more than just materials for housing and commercial real estate. (See Figure 2.) The industry also services the materials demand for infrastructure and other public projects. These factors could substantially impact the industry both globally and domestically thus increasing as a share of the total market and potentially straining supply while increasing prices.

Therefore, domestically speaking, in addition to substantial and likely increasing residential demand over time, expected construction material supply industry growth is also potentially driven by legislation such as the Inflation Reduction Act and the Infrastructure Investment and Jobs Act. These two statutes alone collectively allocate $1.25 trillion for infrastructure in America. Similarly, present and future state and federal programs to encourage home ownership could also contribute to industry expansion.[2]

Further, it is not difficult to imagine that locales with existing or emerging tourist opportunities may require accommodations, resort facilities, and the necessary supporting infrastructure. Utah's ongoing efforts to host

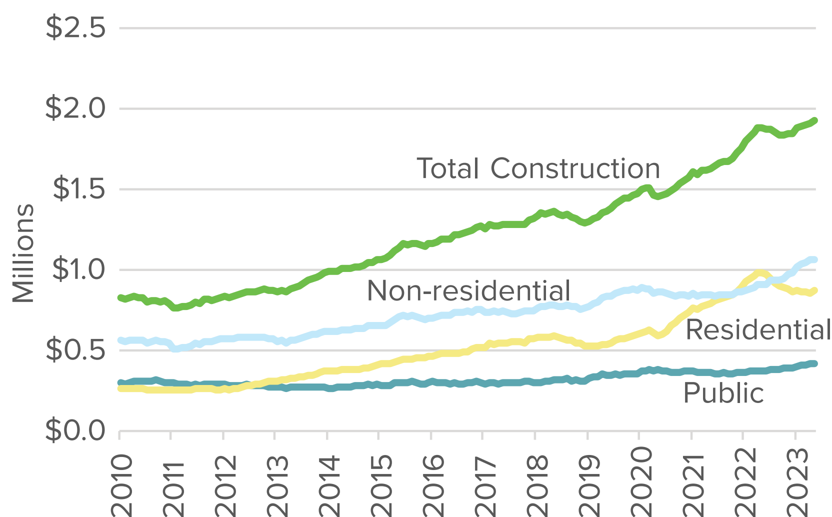
2 Utah State Legislature, S.B. 240 First-time Homebuyer Assistance Program, https://le.utah.gov/~2023/bills/static/SB0240.html.; Dan Green, What is The $25,000 Downpayment Toward Equity Act?, July 18, 2023, https://homebuyer.com/learn/25000-first-time-home-buyer-downpayment-grant.

either the 2030 or 2034 Winter Olympic Games might therefore also strain local construction material supplies.[3]

It is also important to note that the above- described industry growth is not an entirely recent phenomenon and is unlikely to abate over time. For example, annual U.S. construction spending had been increasing well before the recent pandemic related spending boom and remains generally on trend across sectors. (See Figure 3.)

U.S. construction spending had been increasing well before the recent pandemic related spending boom.

Figure 3: Monthly U.S. Construction Spending, 2010-2022



Source: St. Louis Federal Reserve

Surprisingly, given macro level financial conditions, the upward trends in nonresidential and public spending have continued through 2023 with only residential construction moderating by roughly 10% since 2022 – though still remaining near the long term upward trend line going back to 2011.[4] In the case of total construction spending, there has been no statistical moderation and demands placed upon construction material suppliers, subcontractors, and contractors remain notable.

In contrast to the above spending data, annual housing starts in the U.S. have declined by over 22% (over double the decline in residential spending) since 2022, remaining at roughly 1.4 million through 2023.[5] The cause for starts remaining below the long-term trend line is likely related to both higher (and still rising) interest rates since

3 Brian Pinelli, Salt Lake City Bid Maneuvering into Front-runner Position to Host the 2030 Olympic and Paralympic Winter Games, December 6, 2022, https://skiracing.com/salt-lake-city-bid-maneuvering-into-front-runner-position-to-host-the-2030-olympic-and-paralympic-winter-games/.

4 FRED Ecomic, Data St Louis Fed., "Total Public Construction Spending: Total Construction in the Unite States," 2023, https://fred.stlouisfed.org/series/TLPBLCONS#; FRED Ecomic, Data St Louis Fed., "Total Construction Spending: Nonresidential in the United States" 2023, https://fred.stlouisfed.org/series/TLNRESCONS; FRED Ecomic, Data St Louis Fed., "Total Construction Spending: Residential in the United States ," 2013, https://fred.stlouisfed.org/series/TLRESCONS

5 Trading Economics, U.S. Housing Starts, 2023, https://tradingeconomics.com/united-states/housing-starts.

National housing inventory is abnormally low.

Figure 4: U.S. Housing Inventory, 2016-2023

Source: National Association of Realtors

Utah's housing inventory may be poised to be insufficient.

Figure 5: Housing Inventory Levels by Year, 2017-2023

Source: St. Louis Federal Reserve

March of 2022 and broadly tighter lending standards. Predictably given the above, the national housing inventory is also abnormally low and the downward trend curiously pre-dates the pandemic by several years. (See Figure 4.)

The combination of these market realities seems to form the conditions for a building boom to fill unmet consumer demand following any future decrease in interest rates. The currently high home prices (both local and national) may therefore be only a prelude to more pronounced issues that will inevitably impact the construction material supply industry as well as homebuilders and smaller residential clients.

CONSTRUCTION TRENDS IN UTAH

The construction industry currently represents 3.9% of U.S. GDP and an impressive 7% of Utah's GDP.[6] Construction employment in Utah totaled 137,900 as of February 2023, increasing by 9,400 (7%) from February 2022 and 24,200 (21%) from February 2020.[7] This is a predictable outcome of Utah leading the nation in new home construction per capita in early 2023.[8]

Given the above, it is curious that Utah's housing inventory has also not recovered to long-term pre-pandemic levels. (See Figure 5.) It also seems likely that Utah's housing inventory will fall again when interest rates decline in coming years as more buyers flood the market and construction lags in its attempts to fill that rising demand.

6 Associated General Contractors, The Economics of Construction in the United States and Utah, 2020, https://www.agc.org/sites/default/files/Files/Construction%20Data/UT.pdf

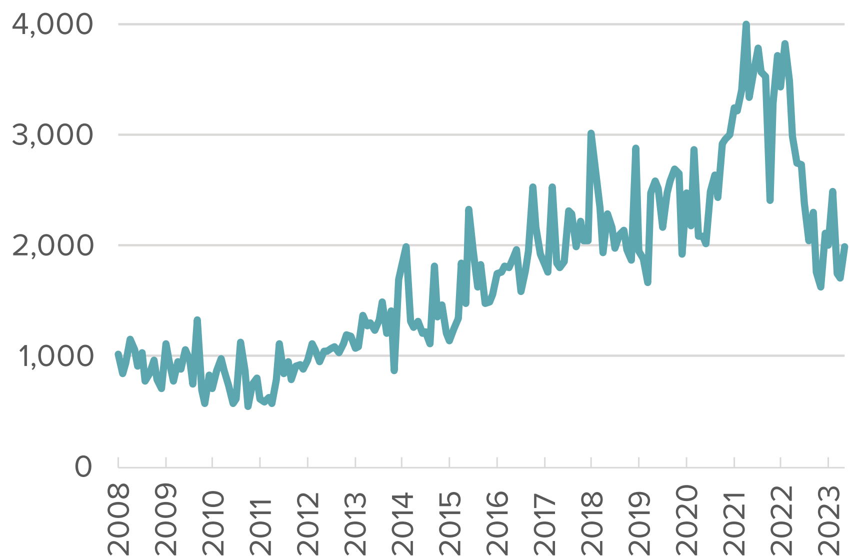
7 Zippia, 25 Essential U.S. Construction Industry Statistics, 2023, https://www.zippia.com/advice/us-construction-industry-statistics/.

8 Charlie Schill, New Study Finds Utah is No. 1 in Residential Construction Per Capita, January 16, 2023, https://www.cachevalleydaily.com/news/archive/2023/01/16/new-study-finds-utah-is-no-1-in-residential-construction-per-capita/; Lehi Free Press, Utah Leads the Country in New Construction Homes Being Built, January 30, 2023, https://lehifreepress.com/2023/01/30/utah-leads-the-country-in-new-construction-homes-being-built/.

Interestingly, Utah's low inventory came to exist in parallel to a historically high number of building permits being issued between 2020 and 2022. (See Figure 6.) Given the dramatic reduction in this number, to a level characterizing the 1990s when migration and housing demand were much lower, Utah may soon face a more serious shortage of housing and construction related resources, including construction supplies, when financial conditions loosen.

Utah building permits decline as interest rates rise.

Figure 6: Utah Building Permits, 2008-2023



Source: St. Louis Federal Reserve

This strong possibility of future growth and expansion in the real estate and construction sectors is also highlighted by a recent survey of the Associated General Contractors of America. Utah's respondents were generally optimistic about 2023.[9]

The respondents highlighted the general belief that the dollar value of 2023 projects would be higher than the previous year. Optimism peaks around the public sector while moderating in the expectations relating to multi-family residential, private office space, data centers, and lodging. The only pessimism exists in the retail sector. [10]

Should this optimism prove well-founded over time, Utah may again face dramatically rising prices and shortages of both labor and construction materials in the future.

This likely expansion could serve to increase the number of new firms being drawn into the construction sphere as contractors, subcontractors, or construction material suppliers. It is also possible that new and perhaps smaller firms bring with them financial instability either at the outset or in the future as market fluctuations inevitably take place.

Of course, policies exist to moderate the macro level impact of potential financial defaults within the construction and construction supply industries. These policies obviously benefit the industry by generating confidence between clients and contractors but also by generating confidence between contractors, construction material suppliers, and subcontractors.

9 Associated General Contractors, 2022 Construction Outlook: Utah Survey Results, https://www.agc.org/sites/default/files/users/user21902/2022_Outlook_Utah.pdf..

10 Ibid.

These policies also potentially encourage competition within the industry by allowing smaller firms to compete more effectively with those that are larger and at least perceived to be well established and financially reliable.

UNPAID DEBTS IN THE CONSTRUCTION INDUSTRY

Background

Utah's construction industry is made up of a diverse group of participants. According to the Utah Division of Professional Licensing, the local construction industry is composed of 31,858 general contractors in 2023. There are also a total of 15,638 licensed electricians and 6,611 licensed plumbers in Utah. Those licensed as general contractors may also consist of framers, masons, architectural planners, roofers, drywallers, carpenters, and many other such roles.

Obviously, companies often contract and subcontract with other companies and suppliers to complete a project. This can create a tangled set of financial obligations. General contractors may default on payments to subcontractors or material suppliers. Similarly, those holding specialized licenses may also default on payment to suppliers of construction materials after having been hired by a general contractor or directly by a homeowner.

The potential for in-state or even interstate conflict among construction material suppliers, subcontractors, and general contractors is ample if only due to the sheer volume of players in the local, regional, and national industries. Conflicts over payment will also likely rise and fall based upon construction activity driven by demand and financial conditions.

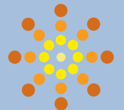
Patterns may not be entirely intuitive and may depend upon economic expansions or contractions. For example, an expanding construction market

may attract new players. The inexperience of these new entrants may result in undue risks being taken with their own or borrowed funds.

The above may become apparent quickly or might not become apparent until business activity begins to slow. More explicitly, a contracting market may find inexperienced firms or actors in the industry financially stressed and result in more financial defaults.

When facing unpaid debts, contractors and suppliers face a number of options. In some instances, creditors may choose to write off the debt as not being worth the work of collecting from financially distressed debtors. In other cases, they may seek judicial redress, even forcing involuntary bankruptcy. In still other cases, contractors may put liens on projects involving real property to collect debts from the property owner. Creditors can sometimes use these liens to force foreclosure on a property, but often this represents too much paperwork and lien holders wait until the property is refinanced or sold to collect their debt.

When creditors seek payment from property owners, it can also sometimes result in property owners paying twice for the construction service. Some states offer additional resources to try to more efficiently address unpaid debts in the construction industry.



Lien Rights Under Threat in Utah?

Lien rights in Utah have historically existed as sacrosanct in the construction sphere as a means by which contractors, subcontractors, and construction material suppliers might recoup funds not paid to them by any individual or firm participating in construction transactions.

Nonetheless, as a way of preventing the filing of liens, homeowners are currently and have been able to receive a certificate of compliance legally highlighting that they have fulfilled their financial obligations. This certificate, along with the exhausting of all legal avenues to collect funds from an individual or firm that has defaulted on their financial obligations, is a prelude to contractors or construction materials suppliers petitioning the now de-funded Residence Lien Recovery Fund for payment.

The issue at present is that, as the recovery fund becomes financially depleted over the coming years, certificates of compliance can legally still be issued resulting in no means by which firms might collect funds from either a state administered fund or from property owners. This seriously limits lien rights for all actors within the construction sphere.

Given the above, it seems that any legislative policy change regarding replacement of the Residence Lien Recovery Fund should also include a reaffirmation of lien rights via conditions placed upon the issuance of certificates of compliance. To do otherwise would severely impact credit conditions within the industry and possibly lead to industry contraction.

How States Ease Unpaid Debts in the Construction Sphere

Aside from the currently implemented Utah State Construction Registry, there are five ways other states do or potentially could help remove the friction of unpaid debts in the construction industry: a state-run recovery fund capitalized by either contractor fees or building permit fees, bond requirements, private insurance, and trust fund statutes. These systems all have several benefits and drawbacks. (See Figure 7.) This report first addresses state-run insurance funds which historically represent Utah's approach.

THE STATE INSURANCE FUND – UTAH'S DEFUNDED SYSTEM

Many states operate funds to cover unpaid debts (sometimes up to a specified limit) that meet specific conditions. Those conditions vary by state as do the funding methods. Some states require payments in addition to existing contractor licensing fees while others have fees associated with building permits.

The Utah Legislature created the Residence Lien Recovery Fund in 1994. Though legislatively defunded in 2018, via its still existing balance the fund still effectively insures subcontractors, homeowners, and construction materials suppliers against the behavior of inexperienced, unlucky, or bad actors operating within the construction industry.

While participation was required, many contractors were also likely content to participate in order to maintain the reputability of licensed contractors and maintain industry stability. The cost was rather modest amounting to a $195 fee paid into the Recovery Fund as part of contractor and subcontractor initial licensure. Every two years, the fund was evaluated and a fee charged on existing license renewal if available Recovery Fund monies were deemed insufficient. Most recently, renewal fees were $112 in 2009 and $105 in 2011.

There exist various workable options for addressing construction defaults.

Figure 7: Potential Approaches for Unpaid Debts

Options	Advantages	Disadvantages	Page
Retain the recovery fund	Simple – existing infrastructure	Higher contractor costs	8/15
The recovery fund + permit fees	Fair and inexpensive	Expensive to administer	15
Construction registry	Essentially free	Logistically very complex	16
Bonding	Fair and inexpensive	Increased contractor costs	16
Insurance	Logistically easy	Expensive (contractors/clients)	18
Trust fund statutes	Inexpensive implementation	Expensive if needed	19

The Utah Legislature defunded the Recovery Fund program in 2018 although the fund will continue to function until all monies have been disbursed. As of the end of fiscal year 2022, the fund balance stood at just under $950,000 which was down from $2.1 million and $1.6 million in fiscal years 2018 and 2020 respectively.

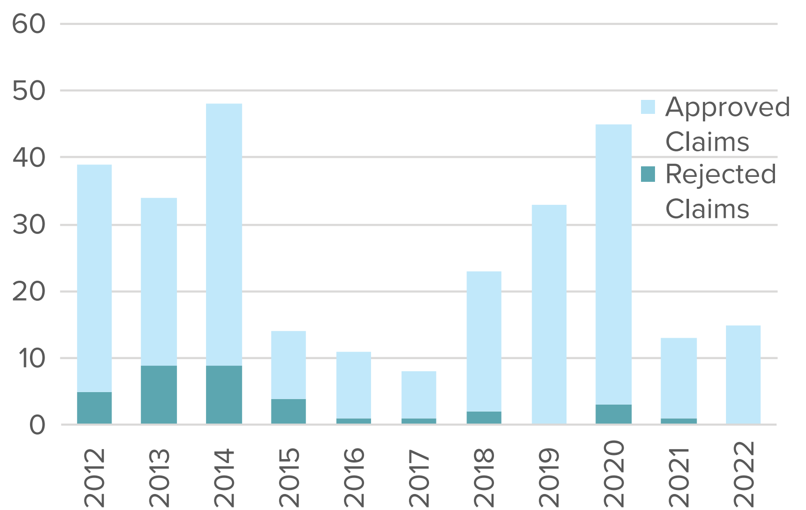
Recovery Fund Claims History

The number of annual claims to the Residence Lien Recovery Fund remained relatively constant between 2012 and 2022, except for the period between 2015 and 2018 when they were relatively low. (See Figure 8 on page 10.) The lack of use in these three years was cited as partial justification for the recovery fund's elimination.

It is also important to note that the total fund payments have significantly increased over time. (See Figure 9.)

Utah recovery fund claims rose after its defunding.

Figure 8: Residence Lien Recovery Fund claims by year, 2012-2022

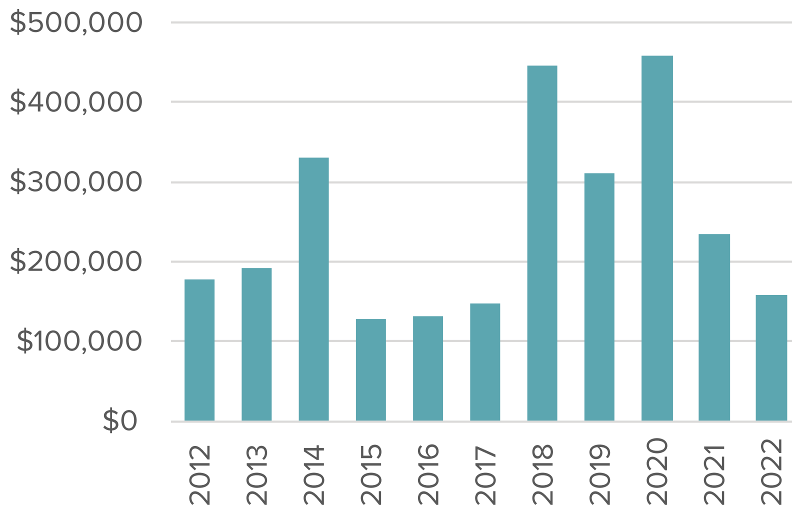


Source: Utah Division of Professional Licensing

While some of this is explainable by price inflation in the value of projects generally, and the prices of labor and materials associated with construction. A substantial amount of this increase is also likely the result of immature actors being pulled into a relatively booming housing market in Utah and finding themselves unable to financially or practically manage the more chaotic construction environment of 2020 and 2021 as prices increased and labor/materials availability waned.

Lien recovery payments spike in 2018.

Figure 9: Residence Lien Recovery Fund Payments by Year, 2012-2022



Source: Utah Division of Professional Licensing

In fact, between 2015 and 2018, the total value of Recovery Fund claims exceeded the total value between 2012 and 2014 by nearly $155,000 even though total claims had fallen from 122 in the initial period to 55 in the latter. This total claim value exceeded what one might expect from inflation alone by roughly 10% in dollar terms. Similarly, total claims value outstripped inflation again between the 2015-2018 time period and the 2019-2022 time period as the total number of claims spiked to 105 over that time period.

It therefore seems that eliminating the fund in 2018 was premature even given the immediate future use of the Recovery Fund. It also seems probable that a good number of these players in the industry have exited this sphere as a slowdown in building has taken place since early in 2022. (There have been no Recovery Fund claims in 2023 as of September 2023.) For this reason alone, it seems likely that funds currently available in the Recovery Fund may last longer than the projected 2025 fiscal year. It is also important to note that, as financial conditions change and expansion resumes, the construction industry may find itself again attracting immature firms back into the state and again face an issue similar to that faced in the last two or three years.

Utah's Defunding of the Recovery Fund and Its Impact on the Construction Market

In 2018, Utah legislators noted a "decreased use" (at least in terms of the number of claims) in recent years and defunded the Recovery Fund. While no claims have yet been made in September 2023, available funds have therefore been dwindling since 2018.

This reality, particularly when combined with accessible certificates of compliance for homeowners, places risk back on the shoulders of suppliers and contractors. That risk may increase, particularly in an environment where building activity may again peak should the U.S. Federal Reserve loosen monetary conditions in the future. Given this, Utah legislators might consider alternatives to the Recovery Fund.

The Default Case: How Firms Might Operate Absent the RLRF or a Viable Substitute

Suppliers and others within the construction sphere will find different ways to manage risk in the absence of the Recovery Fund. These may inject friction into the system and also decrease the competitiveness within the industry.

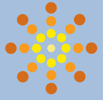
Firms may require cash on the delivery of materials or stage payments on labor undertaken on site. Limiting credit availability throughout an economy also often results in a decrease in the volume of business — in this case, a slowdown of construction activity — which seems an undesirable outcome given Utah's well-known housing deficit. This unfortunate scenario may also result from homeowners, building suppliers, and subcontractors simply avoiding business relationships with smaller and/or less well-established entities. This could possibly lead to an increased market concentration of larger firms perceived as unlikely to default on their payments to subcontractors or construction materials suppliers.

In short, smaller firms are going to become less likely to attract business and more likely to pay a premium (due to the lack of credit) if they do attract business.

While the lack of credit in an industry often results in a decrease in the volume of business, it may be in this case that the lack of a state insurance fund simply results in a reallocation of business activity. If large construction businesses become the only ones reputable enough to which to extend credit, they will likely gather more business and require additional workers or subcontractors to complete their necessary tasks. There may be a niche for the smaller businesses to fill with this increased demand.

However, the concern about fewer businesses within an industry is not necessarily related only to a decrease in activity, but the exercise of monopolistic power. This threatens to increase prices (which could also in turn create less business activity).

Simultaneously, it is not necessarily true that the lack of a state-run insurance fund would truly present a problem. While thought experiments and economic theory may hint at additional frictions in the industry and hardships for smaller or inexperienced firms, the majority of businesses operating in Utah's economy do so without a state-run insurance fund limiting their risk of doing business with some entity which may be unable to satisfy creditors.



The Insurance Paradox

Insurance transfers risk to the insurer which creates adverse selection and moral hazard. The concept of adverse selection suggests that those most likely to need insurance are the most likely to purchase it. Moral hazard comes into play when the risk of a bad outcome is mitigated, resulting in individuals and companies taking fewer precautions. Moral hazard is most relevant to the Residence Lien Recovery Fund.

The Recovery Fund had few precautions against moral hazard and created a potential incentive to "game the system". A firm might be incentivized to conduct business recklessly or move from state to state systematically absconding with funds that should have been paid to subcontractors or materials suppliers.

Moral hazard applies to homeowners as well. If a homeowner is not subject to a major financial loss if a general contractor steals from subcontractors or materials suppliers, that homeowner experiences a reduced incentive to choose a general contractor wisely.

Even more directly, Utah has no such Recovery Fund-type system for commercial development, public infrastructure, or even multifamily developments. Yet construction in these industries moves apace and there is no apparent evidence of uncompetitive markets. Moreover, those at risk from or at risk of generating unpaid debts can and do often purchase insurance to insulate themselves in the private market. Those in the construction sphere are often required to purchase insurance by large scale lenders, or are subject to bonding requirements for larger private or public projects. Perhaps these strategies might be more broadly applied in the residential construction sphere as well.

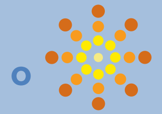
Other State Insurance Funds

There exist a number of similar funds in other states. The Utah Foundation therefore provides a brief summary of these programs highlighting fund contributions, sources, limitations on fund size, and fund withdrawal caps.

In Alabama for example, the lien recovery system is funded by $15 annual fees paid by contractors (both home improvement contractors and those building new homes). This fee is lower than similar fees in many other states, but so are the amounts covered by the fund. It is constrained to $20,000 per transaction with a lifetime cap of $60,000 per licensee.[11]

Fees are higher for Arizona contractors who pay $270 every two years. First-time licensees pay $370, rightly reflecting the higher risk of these licensees

Equity in the Recovery Fund



There are equity issues surrounding all insurance products. Between 1994 and 2018, the Residence Lien Recovery Fund exhibited some notable inequities. Most obviously, it seems inequitable that the Recovery Fund charged the same fee to every contractor regardless of the size of the business itself, the longevity of the business, and the size of the jobs undertaken by the business. Therefore, a graduated fee system charging less for older, larger, and more established firms would seem to be more equitable. Similarly, charging more to firms generally exhibiting higher annual gross project values would be more equitable in that those most likely to withdraw large amounts from the fund are required to pay the most into it. An equitable price structure would consider all of the above factors simultaneously.

Because the insurance fund directly benefits homeowners, subcontractors, and materials suppliers rather than general contractors directly, an alternative funding mechanism that charged the direct beneficiaries would also be more equitable.

Of course, in spite of possible concerns around inequity, there are other principles that legislatures juggle, including transparency, simplicity, and the cost of administration.

11 The Office of Legislative Research, Contractor Guaranty Funds in Other States, November 21, 2019, https://cga.ct.gov/2019/rpt/pdf/2019-R-0258.pdf.

defaulting. Contractors may opt out of contributing to the fund by posting a $200,000 bond in addition to the standard license bond. Contractors within the state are subject to a $30,000 per property and $200,000 lifetime cap on fund withdrawals.[12]

Connecticut maintains separate funds for home improvement contractors and new home builders and neither fund may exceed $750,000. Excess funds are transferred to a consumer protection enforcement account and the state general fund. The annual fee for home improvement contractors is $100 and new home builders pay $480 every two years. There exists a limit of $15,000 per incident for home improvement contractors and a $30,000 limit per occurrence for new home builders.[13]

Hawaii manages a combined fund for both home improvement contractors and new home builders. Contractors pay $150 biennially. If the fund's balance falls below $250,000, fund managers are allowed to assess each home improvement contractor an additional amount of up to $500 per year. In addition, Hawaii's fund balance cannot exceed $420,893. There are also limits of $12,500 per contract and a $25,000 lifetime cap per licensee.[14]

Maryland maintains separate funds for home improvement contractors and new home builders. The fee is $100 for home improvement contractors in their first year and then $125 biennially. If the fund's balance falls below $1,000,000, each contractor must pay an additional $50 (up to three times a year). Simultaneously, $50 from each building permit fee goes to the New Home Builder fund and local jurisdictions may retain 2% of this amount

12 The Office of Legislative Research, Contractor Guaranty Funds in Other States, November 21, 2019, https://cga.ct.gov/2019/rpt/pdf/2019-R-0258.pdf.

13 Ibid.

14 Ibid.

to cover administrative costs. The limits for home improvement contractors are $20,000 per contractor-related occurrence with a lifetime cap of $100,000. For new home builders, the limit is $50,000 per occurrence and a $300,000 lifetime cap. [15]

Massachusetts capitalizes its fund according to firm size. Firms with up to three employees pay $100, four to 10 employees pay $200, 11-30 employees pay $300, and over 30 employees pay $500. If at any point the fund's balance becomes insufficient to pay claims, each home improvement contractor must again pay their original contribution up to one time per year. The fund use limit is $10,000 per homeowner and $75,000 per contractor in a 12-month period. The cap can be waived by the fund manager. [16]

Minnesota also structures its fund payments according to firm size. A combined fund for home improvement contractors and new home builders is funded by $320 contributions biennially for gross annual receipts under $1 million, $420 biennially for gross annual receipts between $1 million and $5 million, and $520 biennially for gross annual receipts over $5 million. The state also imposes a limit to fund usage of $75,000 per transaction and a $300,000 lifetime cap per contractor.[17]

North Carolina capitalizes its fund simply with a $10 surcharge being added to certain city or county building permit fees ($1 is retained by the collecting jurisdiction for administrative costs). Awards from the fund cannot exceed 10% of the guaranty fund balance.[18]

Concrete Housing Construction in Chile; Credit Flikr User Concrete Forms under license (CC BY 2.0)

15 The Office of Legislative Research, Contractor Guaranty Funds in Other States, November 21, 2019, https://cga.ct.gov/2019/rpt/pdf/2019-R-0258.pdf.

16 Ibid.

17 Ibid.

18 Ibid.

Virginia maintains a combined fund for home improvement contractors and new home builders requiring $25 for first time registrants and a $30 biennial renewal. If the fund's balance falls below $400,000, contractors must contribute again up to $50 biennially. There are settlement limits of $20,000 per claim with a two-year cap of $40,000 per contractor. If the contractor does not meet certain financial solvency requirements when registering, a $50,000 surety bond is required.[19]

OPTIONS

Policymakers have several options to consider in the face of sectoral instability as a possible result of the elimination of the recovery fund.

Retain and Fund the Recovery Fund as it Stands?

Even though it has proven legislatively unpopular with large homebuilders, it may be that simply retaining the current Residence Lien Recovery Fund is a workable and potentially preferred option. The contributions to the fund made by contractors are nominal and the burden on the homeowner, absent any conflict, is also minimal. The below described State Construction Registry places a substantial burden on the client or homeowner even before any problem arises. At the very worst, the Lien Recovery Fund only created a bureaucratic labyrinth after default by a contractor or subcontractor and not through every construction project from the outset.

Building Permit Fees as an Alternative

As highlighted by other states, there are alternative funding sources for a state insurance fund. For example, Florida capitalizes their state-run insurance fund with 0.675% of locally collected building permit fees.

The above building permit capitalization system accomplishes two goals. First, it encourages any client or homeowner to acquire a building permit to complete work and only via a licensed contractor. This would enhance municipal revenue as it seems likely that a notable amount of work on homes in the United States is completed outside of any permitting system and using informal sector construction labor. Further, funding such a system through permit fees imposes the cost of insurance upon the most obvious beneficiary rather than any other actor in the construction industry.

It would also certainly increase equity to ensure that the homeowners' insurance fund contributions are dependent upon the total cost of the project in question. Someone remodeling their bathroom should not be paying the same fee as someone undertaking a more substantial and costly project. Further, if everyone undertaking a home remodel contributed to the system in question, the individual cost would likely be low. With low costs, there

19 The Office of Legislative Research, Contractor Guaranty Funds in Other States, November 21, 2019, https://cga.ct.gov/2019/rpt/pdf/2019-R-0258.pdf.

would be little resentment or behavioral change associated with the cost of insurance. The drawbacks are primarily related to the logistics of evaluating and distributing payments and financial management processes being maintained in a centralized bureaucratic way.

The State Construction Registry – Utah's Current System

Beyond the Recovery Fund, the Utah State Construction Registry is the current approach to insulate parties against non-payment. The system requires that projects be registered in a central database and that subcontractors and suppliers be registered. The contract amounts are also registered and homeowners supervising renovation projects (or homebuilders supervising larger projects) can pay individual subcontractors and suppliers directly. Theoretically, this greater transparency should reduce liens for non-payment.[20]

That said, it seems that there are likely a few sticking points. First, there should be legal and/or financial incentives for the general contractor to register the project. In an environment of high demand for contracting services, contractors may insist that the project stay "off the books" in order to initiate work. Similarly, large general contractors may exercise power over subcontractors promising future work (or refusing it) based upon their willingness to participate in a project outside the State Construction Registry.

Further, it also seems that the registry essentially puts homeowners initiating a remodel or new-build clients in charge of managing payments to subcontractors and suppliers. This is partially why homeowners hire general contractors in the first place. Especially with a new home being built, there may be dozens of suppliers and subcontractors.

It seems likely that many homeowners (after weighing the cost of managing suppliers themselves relative to the risk of a lien) will likely turn that job over to their "trusted" general contractor. This, of course, defeats the purpose of the registry entirely.

Financial Liability Bond Requirements

Some states sidestep the need to manage contributions to and administer payments from a state insurance fund by simply requiring licensed contractors to be bonded against financial liabilities. Of course, bonding is when the subcontractor is required to find a surety company that will guarantee the bond amount. The

20 Utah Division of Professional Licensing, State Construction Registry, https://dopl.utah.gov/state-construction-registry/.

surety will determine the bond limit and the bond premium based on the financial stability of the company.

Alaska, for example, requires all licensed home improvement contractors to post a bond in the amount of $25,000. Specialty contractors are required to post a bond in the amount of $10,000. In Arizona, contractors may opt out of the lien recovery fund altogether, but must post a $200,000 bond in addition to their license bond which may reach $15,000 on its own. Similarly, in Florida contractors do not contribute to the lien recovery fund (it is funded by building permit fees) but are nonetheless required to have a bond of between $50,000 and $100,000 insuring their financial obligations. Tennessee, in spite of repealing its lien recovery fund in 1992, implemented a requirement that home improvement contractors maintain a $10,000 to $50,000 surety bond or irrevocable letter of credit for the benefit of anyone harmed due to a lack of contractual fulfillment. Virginia similarly requires a surety bond of $50,000 if firms do not meet state mandated financial solvency requirements. [21]

Surety bond annual premium range from 1% to 10% of the total bond value. Given this and the logistical difficulties in municipalities insuring against contractor or subcontractor default, surety bonds represent a relatively simple and cost-effective way to manage risk. With a simple state requirement that licensed contractors or subcontractors carry bond values appropriate to the firm characteristics, it seems that homeowners, subcontractors, and suppliers could be well insulated against loss.[22]

The disadvantage to bonding is that it is not necessarily common for homeowners to actually ask for proof that a contractor or subcontractor is bonded in this specific way. Homeowners employing contractors,

21 Eric Weisbrot, State by State Guide to General Contractor Bond Amounts, Construction Programs and Results,https://www.markupandprofit.com/articles/state-by-state-guide-to-general-contractor-bond-amounts/.

22 Robert J. Duke, Surety Bonds: The Best Way to Prevent Subcontractor Default, https://suretyinfo.org/pdf/cbo-subdefault.pdf.

subcontractors, and suppliers, both directly and indirectly, are also likely to mistake a required general liability bond for a firm holding a payment and/or performance bond. State requirements for financial liability bonding would therefore optimally be required for licensure to avoid any confusion. Another disadvantage is that, similar to the equity discussion above, the beneficiary is not the party responsible for directly bearing the cost of insurance.

Private Insurance – an Alternative

While bonding requires the contractor or subcontractor to effectively purchase an insurance-like instrument, there exists a difference in that there exists a requirement that surety companies be repaid in the event of bond claims. Another option is the purchase of private construction project insurance by the contractor on behalf of the homeowner with the costs more transparently passed on to them. As there exists no explicit requirement for repayment of insurance claims having been paid, the price would inevitably be higher for insurance than for bonding. The price for private insurance would be determined by actuarial tables representing the statistical likelihood of non-payment between participants. The Utah Foundation spoke with several local construction insurance companies who each asserted that such policies exist but that they did not offer them in particular. A state sanctioned requirement for such policies however, would surely increase availability.

A related option would be to require addenda to contractors' General Liability or Errors and Omission insurance policies that would protect homeowners at the cost of the contractors or subcontractors. Subcontractor default insurance, with financial liability addenda, would also clearly benefit general contractors and could conceivably also benefit building materials suppliers.[23]

23 Andrew S. Zimmerman, Contractor Default Insurance: A Nuanced Alternative to Performance Bonds, May 10, 2013, https://www.grahamco.com/KnowledgeCenter/white-papers/nuanced-alternative-to-performance-bonds/.

An advantage of the above is that these options can generally be made legislatively required elements of construction contracts. In addition, the costs of insurance are likely correlated with the credit history of the firms and individuals in question. They also remove government involvement in the claims process though it would still have a role in the licensure process and enforcement should a firm exclude legally required contractual elements.

Trust Fund Statutes – an Alternative

A more legally focused, and seemingly straight forward, alternative to the above options is trust fund statues. There are currently 19 states that have structured legal language to protect subcontractors, materials suppliers, and consumers.[24]

Such statutes require that payments made to a general contractor are held "in trust" for the client and paid to subcontractors and suppliers as beneficiaries of the trust. The structure of a trust hypothetically prevents trustees from (and potentially punishes them for) combining client funds with the firm's operating funds and (by virtue of being in a trust) protects funds from third party creditors. This system also imposes civil or even criminal penalties (depending upon the state) for violation of the now palpable fiduciary duty. These statutes might also be strengthened by legislatively imposing personal financial liability which is not dis-chargeable in the event of firm bankruptcy.[25]

Other states have more tacitly embraced trust fund statutes. In these cases, a trust is not created automatically by the contract, but can be made an ex-

24 Levelset, Construction Trust Fund Statutes: Guide & FAQs, https://www.levelset.com/construction-trust-fund/.

25 Findlaw, 11 U.S.C. § 541 - U.S. Code - Unannotated Title 11. Bankruptcy § 541. Property of the Estate, https://codes.findlaw.com/us/title-11-bankruptcy/11-usc-sect-541.html.

plicit enforceable element in a contract. California, Maryland, Missouri, and Virginia provide examples of this.[26]

With all construction contracts being de facto trusts, or being made trusts by elements of the contract, the legal consequences for a bad actor are substantial. Homeowners are also insulated from irresponsible (or indeed criminal) actions of a contractor failing to pay their suppliers. Further, personal liability allows the recovery of funds even post-bankruptcy.

The disadvantage (particularly in the realm of the more tacit statutes) is that it advantages more experienced players in the real estate sphere and homeowners who are more contractually savvy. The average person downloading a real estate contract form for his or her general contractor is unlikely to make sure a trust element exists within that contract. It also seems likely that bad actors within the construction sphere will almost certainly exclude trust-related language from their contracts presented to potential clients. Given this, the advantage of automatic trust creation by all construction contracts seems clear.

The Cost of Inaction

The World Trade Organization estimates that 80-90% of world trade is dependent upon short term trade finance.[27] On a much smaller scale, interviews with local construction supply firms have indicated that the vast majority of their sales are financed with short-term credit issued by the suppliers themselves. One group of firms, composing roughly half of Utah's industry, estimates that 96% of their sales are financed on a net-30 basis and that 85% of their current customers would be unable to function absent that free short-term credit being offered.

26 Levelset, Construction Trust Fund Statutes: Guide & FAQs, https://www.levelset.com/construction-trust-fund/.

27 Toolbox, Why Trade Credit Is Important for Construction Businesses, https://www.trytoolbox.com/blog/why-trade-credit-is-important-for-construction-businesses.

It is therefore easy to conclude that a failure to insulate the construction materials suppliers industry from non-payment by subcontractors or general contractors will result in most firms, both large and small, either eliminating or substantially reducing their extension of credit to others within the industry.

This impact will be compounded if Certificates of Compliance within the industry are maintained thus damaging or eliminating the lien rights once possessed by the industry and buttressed by the Residence Lien Recovery fund.

The resultant reduction in credit availability could have a dramatic impact not only upon existing construction material suppliers, but also upon contractors and subcontractors demanding building materials. More importantly an impact upon the broader construction industry and the housing market in Utah will likely take place at the most inopportune of moments. Overall, reduced credit availability in the construction industry can have far-reaching consequences on employment, economic growth, housing affordability, and the financial health of companies acting as both borrowers and lenders.

Delayed or Canceled Projects. One of the immediate and most obvious effects of reduced credit availability might be the delay or cancellation of planned or even initiated construction projects. Developers and construction firms clearly heavily rely upon short term credit to finance their projects, purchase materials, and pay for labor. With abruptly reduced credit access, and the increased implicit and explicit costs of doing business, many projects in Utah may be put on hold or abandoned altogether.

Reduced Investment and Consumption. The construction industry plays a crucial role in broader economic growth and job creation in Utah. A lack of credit could lead to reduced investment in new construction projects resulting in a slowdown of the industry as a whole. This slowdown would

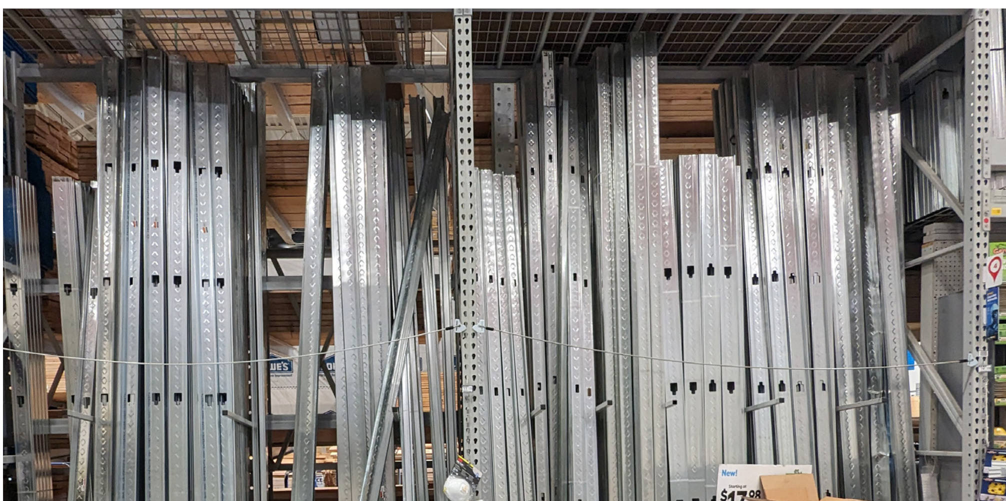
result in fewer job opportunities for construction workers and could have negative multiplier effects upon related industries like real estate, manufacturing, and consumer goods and services.

Lower Demand for Materials and Equipment. Reduced construction activity could also result in decreased demand for construction materials and equipment. While it is clear that a reduction in credit will result in lower demand for construction supplies, the contraction in construction activity will also likely impact the manufacturers of machinery and tools potentially leading to layoffs or business closures.

Financial Stress for Construction Firms. Construction companies often operate on thin profit margins and rely upon a steady flow of credit to manage their cash flow. Reduced credit availability can put significant financial stress on these firms, leading to defaults, bankruptcies, or ultimately anti-competitive consolidations within the industry.

Decreased Housing Affordability. Perhaps most importantly, a contraction in the construction industry emanating from reduced credit availability in the construction materials industry could lead to a shortage of new homes. This could further exacerbate extant housing affordability issues. With fewer new properties available on the market, prices for both new and existing homes may increase, making homeownership even less attainable for potential buyers.

Impact Upon Economic Growth. The construction industry is a major contributor to economic growth, particularly in Utah. A slowdown in construction can have a negative multiplier effect on the broader economy. Reduced construction activity leads to decreased demand for goods and services from other industries, resulting in lower economic output and potential job losses in related as well as unrelated sectors. With the construction industry constituting such a large portion of Utah's total economy, even a 15% contraction in the construction industry could represent a 1% drag on the Utah economy as a whole.



Impact upon the Suppliers Industry. Reduced credit availability impacts not only borrowers but also those acting as lenders. Construction material suppliers will likely face higher default rates and increased credit risks, which may lead to firm failure or to firms tightening lending standards and increased

interest rates when credit is extended. As already noted, this can create a broader credit crunch and impact other sectors of the economy beyond construction. That said, if there is firm failure and consolidation within the construction material supplier sphere, the friction that might be created in the construction industry as a whole as it adjusts to the new reality will likely be systemically detrimental.

Given these potential outcomes, policymakers should carefully manage credit conditions to ensure a balanced and sustainable construction sector, workable housing markets in which affordability is enhanced, and therefore ideally fine tune the state economy as a whole. At the very least, policymakers should be cautious to avoid exacerbating a housing market that is already tight and likely to become even tighter as interest rates fall in the future.

Combining Possible Solutions

The options in this report highlight several ways to protect homeowners, contractors, and suppliers. (See Figure 10.) However, it seems likely that these tools might best be employed in concert with one another.

Questions to assess program viability.

Figure 10: Potential Solutions for Construction Supply Industry Sector Stability

	RLRF/ Contractors	RLRF/ Permit Fees	Construction Registry	Bonding	Private Insurance	Trust Fund Statutes
Who pays the initial costs?	Contractors	Consumers	State/firm/ consumer	Contractors	Consum- ers/firms	N/A
What are the initial costs?	Low	Low	Low	Medium	High	None
Who pays in the event of default?	RLRF	RLRF	Firms	Surety company/ firm	Insurer	Defaulting firm
Costs in the event of failure?	Moderate	Moderate	High	Low	Low	High
Level of complexity for homeowners?	Low	Low	High	Low	Low	High
What is the government's role?	Moderate	Moderate	High	Low	Low	Low
Difficulty to administer?	Moderate	Moderate	High	Low	Low	Low

For example, a state insurance fund financed by building permit fees scaled to the total value of projects combining with a bond requirement for subcontractors and general contractors should cover most unforeseen issues.

Alternatively, bond requirements could be combined with a legal pre-condition that contractors and homeowners collectively purchase contractor default insurance to insulate themselves from liens should the bond requirement somehow prove insufficient.

Further, and in combination with any of the above individual options, state lawmakers might give homeowners legal support by legislating that all construction contracts are, by definition, creating trust accounts.

CONCLUSION

The construction and construction supply industries are critical elements of the Utah and U.S. economies. Specifically, this significance is likely to increase as Utah continues along its current growth path. Protecting clients, subcontractors, and materials suppliers seems helpful as the Utah construction market will also likely continue to fluctuate alongside business activity in the state. Growth pulls new players into a thriving construction market and inevitable stagnation separates healthy from unhealthy firms. Often unsustainable firms leave someone unpaid. The tools described above can be employed in concert to allow the construction industry to thrive through healthy competition and with minimal expense or inequity.

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