



**STATE OF MARYLAND
OFFICE OF THE ATTORNEY GENERAL**

**REPORT REGARDING NEW HOME BUILDER
GUARANTY FUND**

**PREPARED BY THE
HOME BUILDER REGISTRATION UNIT
CONSUMER PROTECTION DIVISION
OFFICE OF THE ATTORNEY GENERAL**

**SUBMITTED TO THE
GENERAL ASSEMBLY
OF MARYLAND**

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I. INTRODUCTION

Prior to January 1, 2001, home builders were not required to be registered or licensed by the State of Maryland.¹ Existing laws provided partial protections for home buyers by focusing on protection of the buyer's deposit, required contract provisions and disclosures, and prescribed terms of non-mandatory home warranty security plans.² The General Assembly heard testimony from home buyers about problems they faced with their builders that were not being adequately prevented or resolved by the then current law. In response to this testimony, the General Assembly in the 2000 Session passed the Maryland Home Builder Registration Act (the "Act" or "HBRA"). The HBRA is designed to provide additional protections to new home buyers by requiring builders to register with the State and by providing an enforcement mechanism that allows the State to prevent builders with a bad track record from continuing to build in Maryland. In enacting the HBRA, the General Assembly also provided that "the Consumer Protection Division of the Office of the Attorney General shall study the feasibility of a new home builder guaranty fund" and "report its findings and recommendations to the Senate Finance Committee and the House Economic Matters Committee."

II. FINDINGS

As discussed below, the Division finds that:

- Current laws provide some protections for new home buyers in Maryland, including laws requiring registration of new home builders, providing protection for consumer deposits, and setting requirements for new home warranties when builders choose to offer them;
- A Guaranty Fund, including procedures allowing consumer claims to be determined using the Office of Administrative Hearings, could provide more comprehensive protection for consumers than under existing laws;
- Models for a Guaranty Fund include the Guaranty Fund currently operated by the Maryland Home Improvement Commission and funds operated in other states;

¹ Montgomery County and Prince George's County have varying forms of builder licensing or registration.

² New Home Deposits, Md. Code Ann., Real Property §10-301 et seq., Custom Home Protection Act, Md. Code Ann., Real Property §10-501 et seq., and New Home Warranty Security Plans, Md. Code Ann., Real Property §10-601 et seq.

- The costs of operating a Guaranty Fund as well as the amount home builders would be required to contribute to any Fund would need to be taken into consideration.

A. **Current Protections for New Home Buyers in Maryland**

1. Home Builder Registration

The Home Builder Registration Unit (the “Unit”) of the Consumer Protection Division of the Office of the Attorney General was created by the HBRA to administer and enforce the Act. The Act establishes a registration procedure that simply requires the disclosure by the builder of necessary information in an application form, and the payment of the required registration fee. The Act does not provide for competency testing or proof of financial responsibility. The Unit has implemented the registration requirements with an objective of making registration an easy and quick procedure. As of June 30, 2003, 2,938 home builders have registered with the Unit.

2. Security for Consumer Deposits

Maryland law currently provides some protection for consumers who pay deposits to builders of new and custom homes. The New Home Deposits Act, Md. Code Ann., Real Property §10-301 et seq., and Custom Home Protection Act, Md. Code Ann., Real Property §10-501 et seq., require builders who collect deposits from consumers to protect those deposits by placing them in an escrow account or by posting a surety bond or letter of credit with the Consumer Protection Division to protect consumer deposits. The statute sets the amount of the surety bond or letter of credit based upon the total amount of deposits held as of May 31 of each year with a maximum required bond or letter of credit of \$500,000. However, the bond, letter of credit or escrow account only protects consumer deposits, but does not provide protection for consumers who have problems with the quality of construction. Further, if all payments are made to a licensed real estate broker to be held in the broker’s escrow account, the builder does not need to provide additional security to protect consumer deposits. Additionally, a builder of custom homes does not need to establish an escrow account or post a surety bond or letter of credit if the builder collects deposits that do not exceed five (5) percent of the home’s contract price or if the custom home contract is financed by a mortgage loan issued by a federally-chartered or Maryland regulated financial institution.

Builders registered with the Unit report that they protect consumer deposits in the following manner:

- 565 registered builders (19.6%) have reported to the HBRU that they protect customer deposits by placing them in escrow accounts;
- 91 registered builders (3.2%) have provided the HBRU with surety bonds and 47 (1.6%) have posted letters of credit;
- 1,017 registered builders (35.3%) have reported that they are not required to provide security for consumer deposits because they use licensed real estate brokers;
- 854 builders (29.6%) report that they do not collect deposits that exceed five (5) percent of the home's contract price; and
- 308 builders (10.7%) report that they do not collect any money from consumers who purchase new homes before the home has been completed.

3. Consumer and Builder Dispute Resolution

Would a Guaranty Fund assist consumers who have complaints about the quality of construction? While there is no central repository of information about consumer/builder disputes, consumer complaints filed with the Mediation Unit of the Consumer Protection Division are illustrative of the nature of complaints against builders as well as how consumers and builders are able to resolve those complaints.

Since January 1, 2001, the Mediation Unit of the Consumer Protection Division handled 580 written consumer complaints filed against 324 different home builders. When a consumer complaint is filed with the Consumer Protection Division, a mediator from the Mediation Unit is assigned. The mediator contacts both the builder and consumer and assists them in resolving their dispute. The Division makes no judgment regarding the merits of the consumer's complaint. A mediated agreement is possible only if both parties are willing to mediate and can reach mutually acceptable terms. The Division also offers binding arbitration at no cost to the parties if the builder and consumer are unable to resolve the complaint through mediation and both the builder and consumer agree to submit their dispute to arbitration.

Of the 580 written complaints, 397 were mediated by the Division's mediation unit; 22 were arbitrated; 57 were filed for information only; 38 were resolved by the consumers without mediation by the Division; 27 were closed after the Division provided advice to the consumer; 11 were referred for investigation or enforcement; 5 were referred to other agencies having jurisdiction; and 23 had other miscellaneous resolutions. 217 of the 397 complaints mediated by the Division resulted in positive relief for consumers, such as the defects being corrected by the

builder or money being paid to the consumer. The total amount of money or savings obtained for consumers in these 217 complaints was \$146,526.63. The Division was unable to resolve the remaining 180 complaints through mediation.

The 580 written complaints raised the following issues; many complaints included more than one issue:

- *Construction Defect Issues* (1,167), including interior finishing (193), exterior shells (156), electric or plumbing problems (151), landscaping (150), foundation or basement defects (118), external structures (118), HVAC issues (83), roofing issues (76), and appliances (20);
- *Misrepresentation Claims* (61), including whether the finished home was constructed in the manner promised by the builder or anticipated by the consumer;
- *Deposit Issues* (82), including consumers seeking return of their deposits after being denied financing or withdrawing from their contract for other reasons;
- *Incomplete Construction* (40), including failure to complete construction following a dispute between the builder and the consumer;
- *Construction Delays* (32);
- *Subcontractors* (17), including failure to pay or identify subcontractors; and
- *Coverage by Home Warranty Service Plans* (29).

A Guaranty Fund could provide additional incentives for builders to resolve complaints through the mediation process. For those complaints that cannot be resolved through mediation, either the consumer or the Unit would need to establish a consumer's entitlement to payment from the fund through a fact-finding process, such as a hearing before the Office of Administrative Hearings ("OAH"). Proceedings before OAH are typically quicker and less expensive for the parties than filing a lawsuit in court.

4. New Home Warranty Law

Maryland's New Home Warranty law does not require home builders in Maryland to offer a new home warranty, but sets requirements that a New Home Warranty Security Plan must meet if a builder chooses to offer a warranty.³ 1,334 registered builders (43.8%) have reported to the Unit that they offer consumers a New Home Warranty Security Plan, while 1,713 (56.2%) have reported that they do not offer a warranty plan to consumers.

³ New Home Warranty Security Plans, Md. Code Ann., Real Property §10-601 et seq.

The General Assembly enacted Chapter 492 during the 2002 Session, transferring responsibility for oversight of plans providing third-party warranties on new homes to the Unit from the Department of Labor, Licensing, and Regulation. Md. Code Ann., Real Prop. § 10-601, *et seq.* This law became effective July 1, 2002, so the Unit has only limited experience with the operation of the warranty programs. The Unit has recently begun collecting information from New Home Warranty Security Plans seeking to operate in Maryland to determine whether the plans meet the requirements of the law. However, based upon consumer complaints received and information provided by existing warranty plans, it appears that some New Home Warranty Security Plans may be providing only limited protection to consumers.

5. Enforcement of Existing Laws

In February of this year, the Unit settled an action brought against a registered home builder from Delaware that filed for bankruptcy and left the homes of many customers on the Eastern Shore incomplete. The Unit also charged that the builder accepted deposits and other monies from consumers in the months before its bankruptcy filing, when it knew it was in financial difficulty and knew, or should have known, that it could not complete construction as promised. The builder did not protect the advance payments made by consumers by placing them in an escrow account or securing them through a bond or letter of credit, as required by Maryland law. Under the settlement, the builder's principals agreed to pay restitution of \$140,000 to consumers whose homes were not completed and \$76,879.58 for deposits collected for homes that were never built.

The Unit has also filed several enforcement actions against unregistered builders who collected deposits from consumers for homes that the builder failed to build, including:

- In April 2003, the Unit obtained a cease and desist order against an unregistered home builder from Greenbelt who contracted to build a home for a consumer in Bowie and collected a deposit of \$27,300, but never built the home or refunded the deposit. The builder is no longer in Maryland and the Unit has been unable to obtain a refund of the consumer's deposit.
- In September 2002, the Unit obtained a cease and desist order against an unregistered home builder who took \$7,539 from a Prince George's County consumer to build a custom home but never began construction, failed to place the deposit in an escrow account, and didn't refund the deposit, as

required by law. The builder is no longer in Maryland and the Unit has been unable to obtain a refund of the consumer's deposit.

- In May 2002, the Unit obtained a final order against an unregistered builder who took \$31,000 from a Prince George's County consumer to build a custom home but never began construction, failed to place the deposit in an escrow account, and did not refund the deposit, as required by law. The builder was ordered to pay a \$100,000 civil penalty for acting as an unregistered home builder and restitution in the amount of \$31,000 to the consumer who was the subject of the case. The Unit has been unable to locate any assets from which it can collect the amounts the builder was ordered to pay.
- The Unit obtained a cease and desist order against a home builder from Delaware who is not registered, but who contracted to build a home for a consumer in Baltimore County, and took \$56,847 in payments. The builder never completed construction of the home and constructed so poorly the portions that were done that the code department for the county issued a stop work order. The consumer had to pay an additional \$24,000 to repair the faulty work done by the builder and other monies to hire outside subcontractors to finish the house. The Office of Administrative Hearings issued a Proposed Decision finding that the builder violated the HBRA, Custom Home Protection Act, and Consumer Protection Act.

Although the Unit has not been able to recover money for injured consumers in these cases, it is unlikely that a Guaranty Fund would assist consumers who lose deposits to unlicensed builders. Traditionally, Guaranty Funds have only provided protection for consumers who have claims against licensed businesses that paid into the Fund. Denying compensation from a Guaranty Fund to consumers who hire unlicensed builders has been justified on the basis that reimbursing those consumers would lessen the incentives for consumers to deal only with builders who have registered.

B. Models for a Home Builder Guaranty Fund1. Home Improvement Guaranty Fund

One such dispute resolution process incorporating OAH proceedings already operates in Maryland. Since 1985, the Maryland Home Improvement Commission has administered the Home Improvement Guaranty Fund, which is financed through assessments paid by all licensed home improvement contractors. Each of Maryland's approximately 12,500 licensed contractors pays a flat assessment of \$100 at the time they are licensed and \$100 with each biennial renewal of the license. The law requires that the fund be maintained at a \$250,000 minimum, but the Commission has discretion to maintain the fund at a higher amount; and it has set the fund level at about \$1 million.

Under the law, claims may be paid from the Guaranty Fund only against licensed contractors. Before money may be awarded from the Guaranty Fund, a formal administrative hearing must be held before the Commission or an administrative law judge, and a finding must be made that the claimant has sustained an actual financial loss as a result of unworkmanlike, inadequate or incomplete work by the licensed home improvement contractor. The homeowner has the burden of proof to establish the validity of the Guaranty Fund claim. Any decision by the Commission to award, or deny, a Guaranty Fund claim is subject to judicial review.

There are certain circumstances under which the Commission may award a claim without conducting a formal administrative hearing. If the claim amount is under \$2,500, the Commission has authority to award a claim without a hearing, if the contractor waives his/her right to a hearing. In addition, the Commission may award a claim, without hearing, if the claimant has obtained a civil court judgment or arbitration award in which a finding of financial loss has been made based upon unworkmanlike, inadequate or incomplete performance of a home improvement contract.

The Commission may not award more than \$15,000 to any one claimant and may not award a cumulative total of more than \$100,000 to all claimants against any one contractor. The Commission may not award money from the Guaranty Fund to compensate for interest, attorneys fees, consequential or punitive damages, or personal injury. Also, a claim must be filed within three years of the time the claimant discovered or, by use of ordinary diligence, should have discovered the loss or damage.

Between 300-400 claims are filed each year against the Guaranty Fund. Claims are initially processed by the Commission's clerical staff. A panel of the Commission then conducts a hearing to determine whether the claims should be delegated to the Office of Administrative Hearings. The parties to the hearing are the consumer, who has the burden of proof, the contractor, and an Assistant Attorney General who presents the position of the Guaranty Fund with regard to whether the claim meets the criteria for payment from the Fund. The Assistant Attorney General representing the Fund may not take a position on the consumer's claim. However, if the claim against the Guaranty Fund is combined with regulatory action against the contractor, an attorney representing the Commission may appear at the hearing. If the case involves regulatory action by the Commission based upon workmanship claims, the Commission will hire an independent expert who is also available to the consumer claimant. However, the costs of pursuing regulatory actions limits the number of Guaranty Fund cases each year in which the Commission is also involved.

The administrative law judge issues a recommended decision to the Commission, which issues a Proposed Decision. Either party may file exceptions to the Commission's Proposed Decision. If exceptions are filed, argument is held before the Commission, which then issues its Final Decision. Approximately 20 cases per year are appealed to the Circuit Court. Payment of the claim from the Guaranty Fund is not made until the appeal is decided. Once a payment is made from the Guaranty Fund, the contractor's license is suspended until the Fund is repaid. The Fund paid out \$890,700 to 175 claimants in FY 2003 and \$948,740 to 218 claimants in FY 2002. The Commission recovers about one-third of the amount paid out of the fund each year from the contractors involved.

The claims that end up at OAH represent only a small portion of the 2,500 complaints received each year by the Commission. The Commission's ten (10) investigators are able to resolve a large number of complaints informally through mediation or negotiation. Additionally, about 800 complaints per year involve unlicensed contractors, in which a Commission investigator files a criminal complaint.

2. Other State Guaranty Funds

A number of other states currently operate Guaranty Funds for home builders, home improvement contractors, or both. For example:

- Alabama's Homeowners' Recovery Fund allows an aggrieved homeowner to recover actual economic damages, not including interest and court costs. Actual economic damages are the reasonable cost of repairing the damages, other than minor cosmetic damages, and must be supported by an itemized list of the actual damages incurred by the homeowner, a description of the repairs, and an estimate by a licensee of the Home Builders Licensure Board of the reasonable cost of making the repairs. The damages must be sustained within the State of Alabama as the direct result of conduct of a licensee in violation of the law, including gross negligence, incompetence and/or misconduct in the practice of residential home building or a violation by a licensed residential home builder of the rules and regulation of the Board. The homeowner must obtain a valid civil court judgment prior to making a claim against the Fund. When a complaint is filed that may result in liability for the Fund, the complainant must notify the Board in writing, by certified mail, when the action is commenced.

Payments from the Fund are subject to the following limitations:

- Total payments for claims based on civil court judgments or settlements against any one licensee can not exceed \$50,000;
- Total payments for claims arising out of the same transaction must not exceed \$20,000;

If the Board pays from the Fund any amount in settlement of a claim or toward the satisfaction of a judgment against a licensee, all licenses of the licensee may be terminated by the Board. The Board may also refuse to issue a new license to the former licensee until he or she has repaid in full the amount paid from the Fund plus interest at the rate of 12 % per annum. A discharge in bankruptcy does not relieve a person from the penalties of the law.

Each licensee must pay a fee not to exceed \$60, no more than once a year, for deposit in the Fund. This annual homeowners' recovery fee is set by the Board after considering all expenses incurred by the Board in defending, satisfying, or settling claims paid from the Fund. The Board has currently set the fee at \$30 per licensee. Alabama currently has about 7,000 licensees.

The Board's staff includes 16 employees, of whom 10 are licensing and administrative staff and 5 are compliance officers. There are also 2 attorneys

and one Deputy Attorney General. In FY 2002, 72 files were opened, meaning that the Fund had been notified that a builder had been sued and that there may be a request against the fund. Of those 72 cases, only 10 claims were paid, totaling \$231,000. The Fund also opened 72 files and has paid out \$95,982 as of June 2003. In 2001, the cap was lowered from \$50,000 per claim to \$20,000 per claim after the Fund paid out more than \$240,000 in claims, which almost bankrupted the Fund.

- Connecticut requires new home builders to register with its Department of Consumer Protection and, every two years, pay \$480 into a New Home Guaranty Fund. Approximately 5,000 registered builders pay into the fund, which is jointly administered with Connecticut's Home Improvement Guaranty Fund. To be compensated from the Fund, a consumer must obtain a civil court judgment against the builder. If the builder has filed bankruptcy, a consumer may be compensated for a claim that was included on the builder's schedules and discharged. Additionally, regulatory action taken by the Department of Consumer Protection against a builder's license could be deemed a judgment against the builder for purposes of claims against the Fund. Consumer claims against the Guaranty Fund are capped at \$30,000 and total claims against the Fund for both home builders and home improvement contractors are capped at \$750,000 per year.

If the fund pays a claim against a builder, the builder's registration is suspended until the fund is repaid. The New Home Guaranty Fund has one full-time employee who reviews and processes consumer claims. The Fund receives about 35 claims per year against new home builders. The majority of claims concern unfinished homes and a limited number concern construction defects. Collection of builder contributions to the fund and regulatory actions against builders are handled by the Department of Consumer Protection. The Department also handles between 500-700 complaints against builders each year that do not result in claims being filed against the fund. If a builder fails to repay the fund, the collection action is handled by a separate State legal office.

- Minnesota requires licensed residential building contractors, including both home builders and home improvement contractors, to pay into the Contractor's Recovery Fund. The contribution amount, which is in addition to any registration or renewal fees, is based on the licensee's gross annual receipts for the preceding fiscal year as follows:
 - \$100 for gross annual receipts under \$1,000,000
 - \$150 for gross annual receipts between \$1,000,000 and \$5,000,000

- \$200 for gross annual receipts over \$5,000,000

In order to obtain payment from the Fund, consumers are required to obtain a civil court judgment against the contractor for fraudulent, deceptive or dishonest practices, converted funds, or failure to perform. The maximum reimbursement amount is \$50,000 for a standard claim, which requires a post-judgment hearing in which the judge orders the fund to pay the claim, or \$7,500 for an accelerated claim, which may be paid by direct application to the fund. No more than \$60,000 may be paid from the fund against any single contractor for standard claims and no more than \$15,000 may be paid in accelerated claims.

The fund is maintained at a level between \$1 million - \$2 million. The contractor's license is automatically suspended upon payment being made from the fund and may not be reinstated unless the contractor repays double the amount paid from the fund plus interest and obtain a surety bond of at least \$40,000. In FY 2003, the fund paid 199 claims totaling more than \$1.8 million. The Contractor's Recovery Fund staff includes an administrator and a staff attorney who process and review claims against the fund. Collection of payments to the fund and licensing are handled by a separate division of the Minnesota Department of Commerce, as are collection actions against contractors who fail to repay the fund.

3. Home Warranty Plans

New Jersey's New Home Warranty and Builders' Registration Act requires all home builders in New Jersey to offer consumers either an approved private new home warranty or participate in the New Home Warranty Program operated by the State.⁴ About one-half of all builders in New Jersey participate in the State program, which enrolls between 5,000 and 6,000 new homes each year. The cost to builders of participating in the State plan is a percentage of the price of a new home that varies depending upon the length of time the builder has been registered and the builder's claims history. Fifteen employees from the New Jersey Bureau of Homeowner Protection are involved in the processing of between 500-600 warranty claims filed by consumers with the State-run program each year.

Montgomery County had a similar program that required home builders to offer either a private warranty or participate in the County's new home warranty security fund. Montgomery County Code, Chapter 31-C. However, the County

⁴ New Jersey Statutes Annotated, § 46:3B-1, *et seq.*

phased out the County-operated fund for any home not enrolled prior to December 31, 1995, due to concerns about the County's potential financial exposure.

III. **RECOMMENDATIONS**

The Division believes that a program similar to that employed by the Home Improvement Commission, in which aggrieved consumers, businesses, and the Guaranty Fund are able to present their cases before an Administrative Law Judge at the Office of Administrative Hearings would provide the most efficient and cost-effective means of providing a judicial forum for determination of claims against the Guaranty Fund. The Division estimates that operating a Guaranty Fund for home builders would require, at a minimum, an Assistant Attorney General, an Administrator, three Investigators, and a Secretary. Based upon the cost to the Division of the positions currently in the Unit, the Division estimates that the annual staffing cost for a Guaranty Fund would be approximately \$372,000.

Additional considerations include the amount each builder would be required to contribute to the fund in order to maintain the fund at a level adequate to protect consumers. If a flat fee were to be paid by builders, each of Maryland's approximately 3,000 home builders would be required to pay an initial assessment of about \$333 in order to initially set the fund at the \$1 million level that the Home Improvement Commission has determined to be appropriate for that industry.⁵ In the 2002 session, the General Assembly, responding to concerns raised by smaller builders about the registration fee they are required to pay under the HBRA, enacted Chapter 530, which lowered the biennial fee for renewing registration from \$600 to \$300 for builders who were issued 10 or fewer building permits during the previous year. A Guaranty Fund would require builders to pay an assessment on top of their registration fee.

A more equitable assessment could be achieved by basing contributions to the fund on an assessment for each home built, would ensure that larger builders pay more than smaller builders. Such an assessment could either be a flat fee per home or a percentage of the home's selling price. Minnesota bases its assessment upon a builder's gross annual income, which, while more equitable than a flat fee, would require builders to submit financial information to the Unit that they are not

⁵ Since there are more than four times as many registered home improvement contractors in Maryland as there are registered builders, the Home Improvement Commission is able to fund its Guaranty Fund based upon a lower per-registrant assessment.

currently required to submit and require the Unit to have adequate staff to review that financial information.

Also, the \$15,000 limit set by the Home Improvement Commission upon the amount that any one consumer can collect from the Guaranty Fund may not prove adequate for claims from a Home Builder Guaranty Fund, since a new home is the most expensive purchase most consumers make. However, the appropriate payout limit would depend upon claims experience. Alabama caps claims at \$20,000 (formerly \$50,000), Connecticut sets a \$30,000 limit on claims, and Minnesota caps claims at \$50,000. Even though it would be prudent to set an appropriate limit on payment of claims from a Guaranty Fund, consumers should not be limited in obtaining a judgment against a builder for the full amount of compensation to which the consumer is entitled through the administrative procedure.

A Guaranty Fund could provide important protection for consumers who purchase new homes in Maryland. However, consideration needs to be given to the costs and parameters of establishing such a program.