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*“The laws are designed to protect the public from incompetent or dishonest providers of building and construction services.”*

## Contractor Disgorgement Judgment may be Dischargeable in Bankruptcy

### THIS ISSUE

We have written several times about the impact of California’s unlicensed contractor disgorgement law – Business and Professions Code section 7031(b). The Ninth Circuit Court of Appeal, reviewing a bankruptcy matter, recently held that a judgment for disgorgement is dischargeable in bankruptcy.

### BACKGROUND

In 2001, the California Legislature amended Business & Professions Code<sup>1</sup> section 7031 to add a disgorgement obligation. The stated intent was to equalize the impact on contractors and those who hire them. Briefly, section 7031 states that a contractor who was unlicensed at any time during the performance of any act or contract for which a contractor’s license was required may not collect money for the work performed. Thus, a contractor suing to collect money must allege in his complaint and prove at trial that he was licensed at all times during construction of the work of improvement.

But contractors who had already been paid were free to keep the money, even though the project owners never had an obligation to pay the contractors. In 2001, the Legislature amended B&P section 7031, adding subsection (b), to change that inequity. It says that anyone who utilizes the services of an unlicensed contractor may sue to recover all compensation paid to the unlicensed contractor.

There have been numerous cases since then interpreting how this new law would be applied. In one case, decided this month, the Fourth District Court of Appeal held that an unlicensed contractor must disgorge all of the money

<sup>1</sup> Further references are to the Business & Professions Code unless noted otherwise.

received, without offset for the costs of materials (even if those materials were incorporated into the work of improvement), without regard to whether the party hiring the contractor knew at the time he entered into the contract that the contractor was unlicensed, and without regard to whether the contractor became licensed at some point during the course of performance of the contract.

It is a harsh ruling, but reflects the Legislature's intention that unlicensed contractors must be deterred from performing work for which a license is required. As one court put it "The laws are designed to protect the public from incompetent or dishonest providers of building and construction services." The Contractors License Laws will be enforced regardless of the harshness of the law and without regard to equitable offsets. And where one court recently held "even where an owner takes calculated advantage of the fact that the contractor is unlicensed at the time the work is performed ... the contractor still may not maintain any action to recover for the work performed" the newest decision goes even further holding that the contractor must disgorge all money received as well, even if he shows that the owner took advantage of him, fraudulently promising that he would pay for the unlicensed work.

The contractor argued that it would be inequitable to allow the homeowner to keep all of the materials the contractor had paid for and incorporated into the residence – especially since the contractor had told the homeowner on many occasions that he was at that time unlicensed, though he was scheduled to take the license exam shortly. Indeed, he did take the exam, and was issued his license during the course of construction.

But the court held that the law required the contractor to "disgorge all of its compensation even if it was unlicensed for only one day of the work." And "unlicensed contractors are required to return all compensation ... without offsets for the value of material or services provided."

There is little hope that courts will be sympathetic to contractors who try to cheat the system, or even those, as here, who are lied to and "cheated" by savvy homeowners who understand the laws better than the unlicensed contractor does.

As one court ruled:

An offer, or acceptance of a solicitation, to perform unlicensed contract work is illegal. If the work offered or solicited is performed without a license, the contractor must rely solely on the other party's good faith for payment, and a claim for compensation will be disallowed under section 7031, regardless of the balance of equities or the manner in which the claim is framed. Proper application of section 7031, and of the other sanctions provided by the CSLL, thus rightly discourages contractors from entering arrangements for unlicensed work.

### **RELIEF FROM BANKRUPTCY COURT**

All of this is obviously very bad news for unlicensed contractors. But the Ninth Circuit Court of Appeal recently rendered an opinion that may provide some relief for those facing a judgment for disgorgement of money received for unlicensed work.

An exhaustive review of bankruptcy law is beyond the scope of this newsletter (and beyond the expertise of this author). But the high level rule is that if a judgment is entered against a debtor for fraud, that judgment usually cannot be discharged in bankruptcy.

In one recent case, in which the homeowner alleged fraud, judgment was entered against an unlicensed contractor. The fraud allegation was supported by evidence that the contractor lied to the homeowner, telling him that the contractor was licensed (he was not), and on that basis the homeowner entered into the contract, and paid money to the unlicensed contractor that he was not obligated to pay. The trial court found all of this to be true, but also found that there was no actual damage caused by the misrepresentations, since the homeowner received something of value in exchange for the payments.

The trial court nevertheless found in plaintiff's favor, and entered judgment, based on B&P section 7031(b) that the contractor must repay all money received. The unlicensed contractor filed for bankruptcy, and the homeowner opposed the contractor's discharge, arguing that the contractor acted fraudulently in concealing his unlicensed status from the homeowner.

The bankruptcy court of appeal found that there was no judgment for money based upon fraud – since there were no actual damages. Rather, the money was owed because section 7031(b) requires disgorgement of money received – which is enforceable without regard to fraudulent conduct of the unlicensed contractor. Thus, the bankruptcy Court of Appeal found, the judgment was indeed subject to being discharged in the normal manner of bankruptcy court.

The Court was especially careful to say that in the case where a contractor was found liable for fraud based upon matters other than his licensed status, the ruling might not apply. Obviously, this is a case by case analysis, and requires competent counsel practiced in this area of law.

For example, in another case on this subject, decided in 2007, the trial court entered judgment against the contractor on the basis of 7031(b), but also on the basis that the contractor made other material misrepresentations in the negotiation of the contract. On that basis, the trial court also awarded \$30,000 in punitive damages against the contractor. In that case, at least, there were fraud damages, and it is an unclear question whether the Bankruptcy Court of Appeal decision would have provided the judgment debtor relief.

## CONCLUSION

The very harsh Contractors' License Law is intended to ensure that there are no loopholes for unlicensed contractors to skirt the license requirements. But there may be some relief available to unlicensed contractors against whom judgments are entered pursuant to 7031(b) for disgorgement, if they otherwise qualify for bankruptcy discharge.

## NEXT ISSUE

Judicial review of arbitration awards.

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