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“The failure to purchase worker’s compensation insurance – even years before – could cause a contractor to be deemed unlicensed in future matters.”

Loss of Contractor’s License by Worker’s Compensation Fraud

THIS ISSUE

California’s Insurance Commissioner recently identified worker’s compensation fraud as a pervasive problem in the construction industry. But the risks of worker’s compensation fraud have increased substantially, and the practice may be curtailed significantly.

FACTUAL SCENARIO

The court of appeal upheld a judgment against a contractor who had defrauded the worker’s compensation system and his clients. The impact of this decision will be significant, and may affect the contractor playing field by dramatically increasing the penalties for contractors who fraudulently underreport the wages of their workers.

Laurence Harcourt “Jay” Wright did a small amount of construction work for homeowner Ghyath Issak. Issak refused to pay for a portion of the job, citing poor quality workmanship, significant budget overruns and lack of documentation of expenses alleged to have been incurred. Predictably, Wright recorded a mechanic’s lien against Issak’s home and thereafter brought suit to foreclose the lien. Issak cross-complained for fraud, and alleged that Wright was not a licensed contractor by virtue of his failure to “obtain and maintain” worker’s compensation insurance as required by the California Contractor’s License Law (Business & Professions Code section 7125.2).

In responding to the allegation that he was an unlicensed contractor, Wright contended that he was fully licensed at all times and did have worker’s compensation insurance. He relied on a “certificate of insurance” to show that he had an account in good standing with the State Compensation Insurance Fund. On that basis, he contended, he was properly insured.

But State Compensation Insurance Fund's records showed significant underreporting of wages. In Wright's periodic wage reports, submitted under penalty of perjury, he reported only \$312 in employee wages over a two and a half year period and paid less than \$150 in worker's compensation premiums. His wage reports routinely claimed zero or next to zero wages.

At trial, Issak proved that contrary to the "zero wages" he reported in 2004, Wright had actually paid workers for over 4,000 man hours, totaling approximately \$135,000 in wages. The court held that as a matter of law, Wright could not "obtain" worker's compensation coverage by fraud, and thus he failed to meet the "obtain and maintain" worker's compensation requirement to retain his licensed status.

As a result of his failure to obtain worker's compensation insurance, Wright was found to be an unlicensed contractor. Judgment was entered against him both on his complaint to enforce the mechanic's lien and judgment on the cross-complaint, forcing him to disgorge all money paid to him. The court found him liable for fraud, and assessed punitive damages against him. Also, the court awarded attorney's fees and costs to the defendants, resulting in a judgment against Wright in excess of \$130,000.

Wage Reporting Requirements

Contractors typically report the wages of their workers after the fact on a monthly or quarterly basis. A contractor must state the total hours worked by employees and multiply that number by an interim rate determined by the kind of work performed (roofers' rates are higher than carpet layers', for example). The resulting dollar amount is submitted with the wage reports.

Loss of License for Failure to Purchase Worker's Compensation Coverage

Business and Professions code section 7125.2 states that the failure to "obtain or maintain" required worker's compensation insurance shall result in the automatic suspension of the contractor's license as a matter of law. The suspension is effective upon the earlier of 1) the date on which the relevant coverage lapses, or 2) the date that coverage was required to be obtained.

In an effort to evade this automatic suspension, Wright claimed that he never received notice of the suspension of his license, and therefore, he argued, he continued to be licensed. The court disagreed, holding that since he never obtained the required worker's compensation insurance, his license was suspended by operation of law, and no notice was required. His license was suspended long before he performed the work for Issak – possibly at the time he submitted the first fraudulent wage report stating that he had "zero" payroll.

Importantly, once suspended, the contractor's license remains suspended until the contractor demonstrates to the Contractors State License Board that he has remedied whatever caused the license to be suspended. Thus, the failure to purchase worker's compensation insurance – even years before – could cause a contractor to be deemed unlicensed in future matters.

Impact of Non-Licensure

As reported in the March 2009 issue of R.E.A.C.H., unlicensed contractors may not collect for any portion of the work they performed, regardless of the merits of their case and regardless of the equities. All labor, materials, and other out-of-pocket costs are lost if the contractor cannot prove his licensed status at all times during construction.

Thus, Issak was successful in defeating Wright's claim for foreclosure of mechanic's lien by showing that Wright was an unlicensed contractor by operation of law. Equally important, though, Issak was successful in his cross-complaint, and is entitled to recover all money paid for any "act or contract" for which a license was required. This is true regardless of the quality of work, cost of materials, or other "equities" of the case.

This Decision Should Level the Playing Field

For many contractors who properly pay their required worker's compensation and other costs of doing business, it was very difficult to compete against their non-law-abiding competitors who saved money by cheating the system. But after this ruling, a client who can prove that his contractor deliberately underreported the wages of his workers to his compensation carrier may be able show that the contractor was unlicensed as a matter of law. If a contractor is unlicensed, the client can refuse to pay the contractor and may recover all money paid to the unlicensed contractor.

CONCLUSION

One of the first steps in defending against a claim for money by a contractor is to determine the license status of the contractor. In researching this, an owner may consider an examination of that contractor's worker's compensation records. The results could be an unexpected windfall for the owner. By contrast, a contractor who intentionally underreports his wages to the Worker's Compensation Insurance Fund should heed the lesson of *Wright v. Issak* and begin making those payments – including back payments – right away.

In addition, he should consult with an attorney about the appropriate means of ensuring that he continues to be licensed in spite of a prior failure to report all wages. While the results may seem harsh, the court of appeal has held that the public good to be gained by forcing contractors to comply with the requirement that they purchase worker's compensation insurance outweighs any inequity to the contractor.

NEXT ISSUE

Commercial lease liquidated damage claims.

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