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*“the authorization of recovery of ‘all compensation paid to the unlicensed contractor ...’ means that unlicensed contractors are required to return **all** compensation received without reductions or offsets...”*

## Contractors Must Disgorge *all* Money Received for Unlicensed Work

### THIS ISSUE

The law regarding unlicensed contractors has undergone significant change recently. This month we report on a recent appellate decision holding that an unlicensed contractor must disgorge all money received for the unlicensed work, without offset for costs incurred and without regard to the value of goods and services provided.

### LEGAL BACKGROUND

In June, we reported again on the case of *Wright v. Issak*, which held that a contractor who did not purchase required worker’s compensation insurance became an unlicensed contractor as a matter of law, without regard to whether the contractor received notice of the suspension of his license. This month, we report on a case decided in July 2009 that expands upon the already harsh holdings against unlicensed contractors. In the matter of *White v. Cridlebaugh*, the court of appeal held that an unlicensed contractor is not entitled to offset a judgment for disgorgement against the costs incurred in performing the construction.

Some legal background will be instructive. In California, as in many jurisdictions, an unlicensed contractor may not bring any action to recover money for the performance of any act or contract for which a contractor’s license was required. The California Supreme Court has held that the law is intended to be harsh in order to force contractors to comply with the law. Nevertheless, one California appellate decision held that while a contractor was not entitled to bring an action to recover money, he was nevertheless allowed to keep any money he had already been paid. In 2001, the California Legislature amended the Contractors’ State License Law (“CSLL”) to eliminate the inequitable situation

created by that case, where those homeowners who had already paid for services were in a different position than those who had not yet paid the contractor. The new law said that not only is an unlicensed contractor prohibited from bringing any action to recover money, the unlicensed contractor must also pay back any compensation he received during the course of his work.

Against this backdrop, a number of legal treatises opined that an unlicensed contractor who was forced to disgorge the amount received during construction was nevertheless entitled to an offset for the actual costs incurred by the contractor during construction. Thus, those treatises suggested, the costs of labor, materials and even subcontracts for services, could be deducted from the amount the owner was entitled to recover from the contractor. But that too changed this year, with the decision in *White v. Cridlebaugh*.

## FACTUAL BACKGROUND

These facts are taken from the factual background section of the *White v. Cridlebaugh* decision:

The Whites purchased an empty lot in Pine Mountain Club in 2005 for the purpose of building their retirement home. The Whites had been looking at log homes for a number of years, and White obtained estimates on log home packages.

The Whites met the Cridlebaughs at church and decided that since the Whites needed to have a house built and the Cridlebaughs needed work, it might be a good fit. Although the contract listed the owners as the general contractor, White testified that his understanding with Cridlebaugh was that Cridlebaugh would do the actual work on the site and was responsible for reading the plans and doing the work on the drawings.

In March 2006, Cridlebaugh began clearing brush from the site, but soon ran into complications with the excavation and grading required. White became concerned and asked Cridlebaugh to subcontract the grading work to L & M Construction, which was

familiar with the area and had equipment on the hill where the Whites' lot was located. White also asked Cridlebaugh to get a rebar contractor to do the rebar because Cridlebaugh did not have anyone experienced to do the work.

White also was concerned with the billings he received from JC Master Builders, Inc., the Cridlebaughs' construction company. There were various discrepancies in the invoices, such as lack of specificity of material and labor costs, and apparent miscalculation of the costs of laborers. White asked Cridlebaugh for the invoices from the suppliers several times but they were not provided. White was concerned that unpaid suppliers might place a lien on the lot. Through mid-May, 2006, White paid the bills of JC Master Builders, Inc.

On June 19, 2006, White sent Cridlebaugh a memo confirming his oral instructions to Cridlebaugh to stop all construction activities until he provided the original documents requested by White to verify the billings. On June 22, 2006, White sent Cridlebaugh a letter stating that the relationship was finished. On July 14, 2006, JC Master Builders, Inc., filed a mechanic's lien in the amount of \$13,561.62 against the Whites' lot.

### *Unlicensed Contractor Status*

When a corporation, such as JC Master Builders, Inc., applies for a contractor's license, it must qualify through either a "responsible managing officer" (RMO) or "responsible managing employee" (RME), who is, him or herself, eligible for the same license qualification. The "qualifier" RMO or RME must be a bona fide officer or employee of the corporation and actively engaged in work encompassed by the license.

If the qualifier is disassociated from the licensed entity, the entity has 90 days to replace the qualifier. If the qualifier is not replaced, the contractor's license issued to the entity is automatically suspended.

In this case, JC Master Builders, Inc., was not qualified for a contractor's license because (1) the RME was not actively engaged in its construction business after August 2004, (2) Cridlebaugh did not have a contractor's license, and (3) no replacement was ever qualified in the RME's place. Therefore, JC Master Builders, Inc.'s contractor's license was suspended by operation of law.

### ***Disgorgement for Unlicensed Work***

The CSLL encourages licensure by subjecting unlicensed contractors to criminal and civil penalties. The criminal provisions state it is a misdemeanor for a person without a license or an exemption to act in the capacity of a contractor. The civil penalties affect the unlicensed contractor's right to receive or retain compensation for unlicensed work. As reported in the March and June 2009 issues 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. To use the court's words: "The statutory language demonstrates the Legislature's 'intent to impose a stiff all-or-nothing penalty for unlicensed work. ...'"

But the Cridlebaughs argued that they had invested a great deal of money in the building of the White's home, and that the Whites would be unjustly enriched if they were allowed to receive the benefit of that work while at the same time recovering back from the Cridlebaughs all of the money they had spent building the home. They should be, the Cridlebaughs argued, entitled to an offset for the amount they actually expended for the Whites' benefit.

The trial court considered the impact of the law on the Cridlebaugh's argument:

"[I]t's not a matter of equity, it's not a matter of balance, it's a matter of policy behind the licensing laws and the results are harsh. They have become

harsher since 200[1] with the amendment to that section because the Court's motion for directed verdict will include not only a judgment for dismissal of the affirmative claims of JC Master Builders, an order to dissolve the mechanic's lien, but an order for disgorgement of all amounts received under the contract by JC Master Builders; that being the \$84,000 and change...."

The trial court discussed the potential harshness of this result, recognizing that the jury could conclude from the evidence and arguments that JC Master Builders, Inc., had done a good job and an appropriate job with the Whites getting a better place than originally contemplated.

And the court of appeal agreed. The result is harsh, but that is what the Legislature intended. Even though the Whites may have benefitted significantly at the Cridlebaugh's expense, they were nevertheless entitled to a full recovery as a matter of law.

### **CONCLUSION**

The California Supreme Court has harshly interpreted the CSLL against contractors who are unlicensed. And the law allows for suspension of the contractor's license without notice in those cases where the contractor intentionally violates certain sections of the CSLL, such as the mandatory workers' compensation insurance provisions, or, as here, the operation of a construction company without a qualified RME or RMO.

Disgorgement of all money paid, not merely profit, is the end result. It is harsh, but it is intended to be so in order to encourage contractors to obey the Contractor's State License Laws.

### **NEXT ISSUE**

Some common mistakes in residential purchase agreement form contract interpretation.

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