BUSINESS & PROFESSIONS CODE § 7031, THE MOST POWERFUL CONSTRUCTION STATUTE IN CALIFORNIA:

HOW TO REMODEL YOUR HOME ABSOLUTELY FREE!

BY IAN CORZINE, ESQ.

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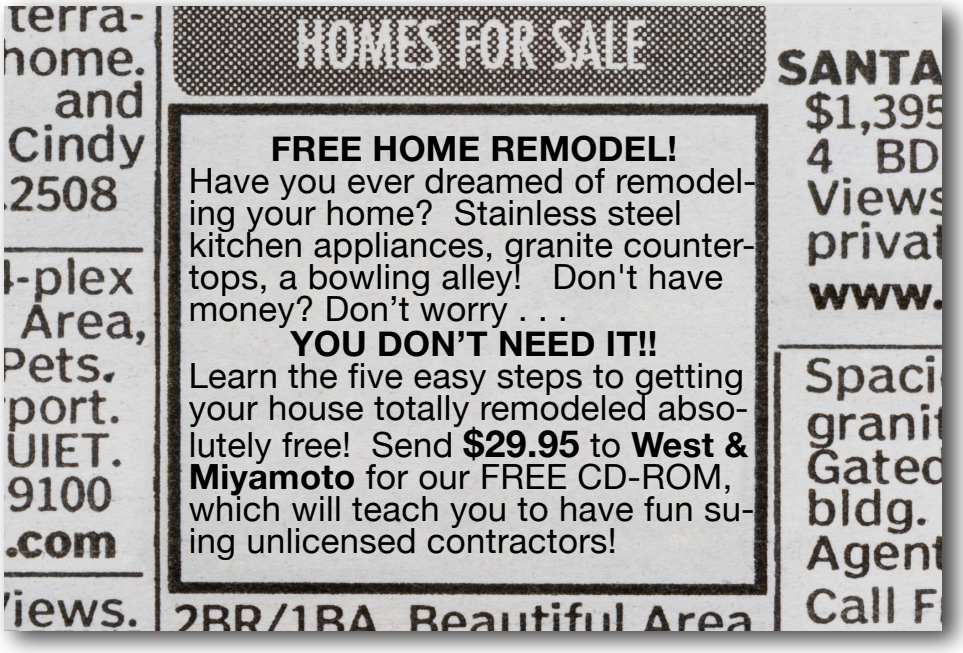
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Introduction

You're too smart to fall for this ad, right? Well, you don't have to. You don't even have to send the $29.95 to learn about the extraordinary provisions of California Business & Professions ("B&P") Code § 7031. Unbelievably, the ad is entirely true and based on California law. To "protect" the public, the California Legislature enacted § 7031(a) in 1939 and § 7031(b) in 2001. Subsection (a) penalizes contractors, who were unlicensed during the time they performed construction, by depriving them of standing to sue for recovery of contractual compensation. Subsection (b) enables individuals who utilized the services of an unlicensed contractor to sue and recover, not just profits, not just payments made during an unlicensed period, but all compensation they paid. This is true even if the project was entirely completed. You can recover even if you knew your contractor was unlicensed before you signed the contract.

After handling litigation involving the statute, it becomes evident that § 7031 creates a "windfall" for those who hire unlicensed contractors. Section 7031 approves of unfairness as a means to punish contractors who allow their licenses to expire. Surprisingly, the statute's singular effects have been recognized and approved by the California Supreme Court. *See MW Erectors, Inc. v. Niederhauser Ornamental and Metal Works Co.*, 36 Cal. 4th 412, 444 (Cal. 2005).

In day-to-day practice, however, § 7031 causes many problems. Most contractors' licenses are not invalid for the run of the project. Sometimes a small mistake leads to revoked or suspended status. Other times, the contractor himself is validly licensed, but an bureaucratic obstacle delays issuance of the license to his business entity. Amazingly, the unli-

censed period triggering § 7031 provisions may only be a day!

Claims involving § 7031 also create difficulties for claims professionals and attorneys handling construction litigation. Questions concerning insurance coverage, retainer of coverage counsel, taking appropriate procedural steps, and settling disgorgement claims abound. The presence of a § 7031 cause of action infuses emotional tension in contractors and their insurance companies.

The purpose of the following materials is to make the construction industry aware of the unique provisions and ramifications of § 7031. For ease of understanding, the materials are separated into four main sections. In the first, we address the basics of California contractor licensing law so that the reader may know § 7031's background. In the second section, we summarize the penalties attendant to violating contractor licensing law while validly licensed. We also examine the adverse consequences of performing construction work while unlicensed. In the third section, we discuss the ultimate penalty for unlicensed construction work embedded in § 7031 and review various applications of the statute. The final section provides guidance for claims professionals and attorneys on the proper handling of cases involving § 7031 claims.

After reading these materials, you will learn the "five easy steps to getting a free remodel." And you will probably agree with us when we say, "Business & Professions Code § 7031 is the most powerful construction statute in California!"

CA CONTRACTOR LICENSING

Regulation of Contractors

B&P Code §§ 7000 - 7191 provide the rules that govern construction contractors who work in California. These statutes are administered by a 15-member contractor committee, called the "Contractor's State License Board." As a part of its duties, the Board appoints its chief executive, the "Registrar of Contractors." The Board also considers and adopts regulations that implement California's construction licensing law.

Purpose of Licensing Law

The Board's highest priority is protecting the public from contractor dishonesty and incompetence. Cal. Bus. & Prof. Code § 7000.6; *Lewis & Queen v. N.M. Ball Sons*, 48 Cal. 2d 141, 149-50 (Cal. 1957). Perhaps, ironically, "[t]he licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business." *Hydrotech Systems, Ltd. v. Oasis Waterpark*, 52 Cal. 3d 988, 995 (Cal. 1991).

To accomplish the objective of the licensing law, the Legislature and Board included detailed provisions on contractor licensing and disciplinary proceedings in the B&P Code and related regulations. Cal. Bus. & Prof. Code §§ 7065 - 7077, 7090 - 7124.6; Cal. Code Regs. tit. 16 §§ 810-890 (2008). These laws entirely preempt conflicting city and county ordinances. Cal. Bus. & Prof. Code §§ 460, 7032. However, cities and counties are permitted to regulate the quality and character of contractors' installations through a system of permits and inspections. *Id.* at § 7032.

Who Is a "Contractor?"

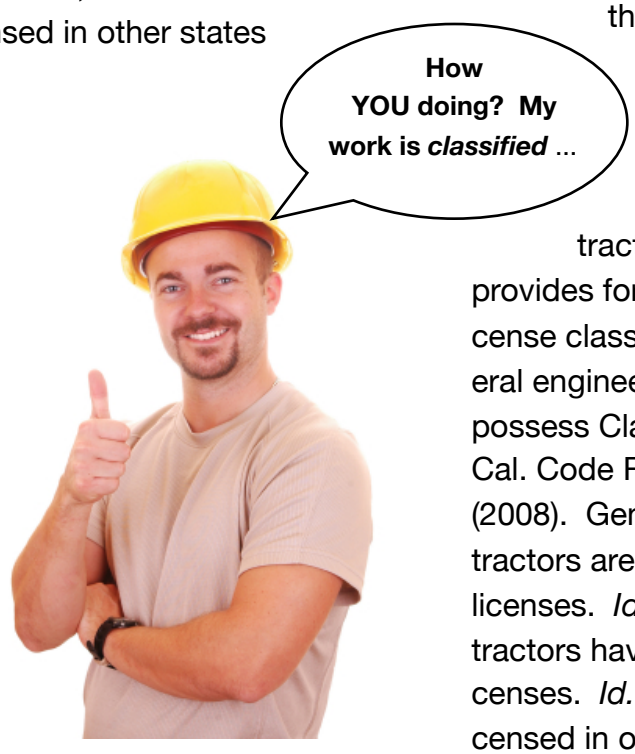
A California "contractor" is: [A]ny person who undertakes to or offers to undertake to, or purports to have the capacity to undertake to, or submits a bid

to, or does himself or herself or by or through others, construct, alter, repair, add to, subtract from, improve, move, wreck or demolish any building, highway, road, parking facility, railroad, excavation or other structure, project, development or improvement, or to do any part thereof, including the erection of scaffolding or other structures or works in connection therewith, or the cleaning of grounds or structures in connection therewith, or the preparation and removal of roadway construction zones, lane closures, flagging, or traffic diversions, or the installation, repair, maintenance, or calibration of monitoring equipment for underground storage tanks, and whether or not the performance of work herein described involves the addition to, or fabrication into, any structure, project, development or improvement herein described of any material or article of merchandise. Cal. Bus. & Prof. Code § 7026.

The term includes those characterized as subcontractors or specialty contractors. *Id.* "[P]erson" includes: "an individual, a firm, copartnership, corporation, association or other organization, or any combination of any thereof." Cal. Bus. & Prof. Code § 7025. While architects and engineers often consult with contractors, they are not required to obtain a contractor's license. "Owner / builders" generally need not be licensed. Cal. Bus. & Prof. Code § 7044. Gardeners are not included in the definition of "contractor," unless they perform work on "landscape systems and facilities." Cal. Code Regs. tit. 16 § 832.27 (2008). Further, performance bond sureties are not required to be licensed if they retain only licensed contractors to complete the construction work. Cal. Bus. & Prof. Code § 7044.2.

Out-of-State Contractors

Often, contractors licensed in other states desire to complete construction work in California. In these situations, the B&P Code provides a method for contractor license reciprocity. To obtain an examination waiver, the out-of-state contractor must be from a state that accepts California's contractor licensure qualifications. Cal. Bus. & Prof. Code § 7065.4. The state must also provide for qualifications and conditions of good standing for licensure that are at least as stringent as those in California. *Id.* Assuming these criteria are satisfied, the out-of-state contractor must submit written certification from the state in which he is licensed that his license has been in good standing for the previous five years. *Id.*



Contractor Classification

California contractor licensing law provides for three main license classifications. General engineering contractors possess Class A licenses. Cal. Code Regs. tit. 16 § 830 (2008). General building contractors are issued Class B licenses. *Id.* Specialty contractors have Class C licenses. *Id.* Contractors licensed in one classification

may not contract in the field of any other classification unless they are also licensed in that classification or perform certain "incidental and supplemental" work essential to complete the work for which they are licensed. *Id.* Class C contractors are further organized in sub-classifications. The 42 different sub-classifications include those for demolition (C-4), lathing (C-26), masonry (C-29), and roofing (C-39). Cal. Code Regs. tit. 16 § 832 (2008). Definitions of each Class C contractor sub-classification appear at California Code of Regulations §§ 832.02 - 832.61.

Business Entity Contractors

When we use the term, "contractor," in daily discussions, we often assume the contractor is an individual. However, many "contractors" are business entities, such as partnerships, corporations, or joint ventures. As stated above, such business entities fall within the definition of a "person" authorized to perform construction work in California. *See* Cal. Bus. & Prof. Code § 7025. To qualify a partnership as a "contractor," a previously licensed partner or Responsible Managing Employee ("RME") must complete and obtain Board approval of an "Application for Original Contractor's License." An RME is defined as: "an employee who is permanently employed by the applicant and is actively engaged in the operation of the applicant's contracting business for at least 32 hours or 80% of the total hours per week such business is in operation, whichever is less." Cal. Code Regs. tit. 16 § 823 (2008). Additionally, an RME must exercise direct supervision and control of his employer's operations as required to secure compliance with California contractor licensing law. Cal. Bus. & Prof. Code § 7068.1.

A corporation may be a contractor if its Responsible Managing Officer ("RMO") (i.e., corporate version of a RME) or RME completes and obtains Board approval of a license application and a "Licensed Sole Owner Applying for Corporate License" form.

The Board may issue a joint venture contractor license to any combination of individuals, partnerships, corporations, or other joint venturers. Cal. Bus. & Prof. Code § 7029. The main requirement is that at least one of the joint venturers must possess the license classification that the joint venture seeks. *Id.*

Becoming a "Contractor"

Written Examination

To obtain a contractor's license, an individual must take and pass a written examination pertaining to the particular license classification he or she seeks. Cal. Bus. & Prof. Code § 7065. The examination may be waived if an out-of-state contractor satisfies the requirements set forth in B&P Code § 7065.4.

Good Character and Financial Solvency

An applicant for a contractor's license must not have been convicted of crimes or committed fraudulent or dishonest acts. Cal. Bus. & Prof. Code §§ 480, 7069. Further, he must prove "financial solvency," i.e., he possesses operating capital exceeding $2,500. Cal. Bus. & Prof. Code § 7067.5.

Bonds

In accordance with its public protection purpose, the Board requires applicants for an original contractor's license or renewal of a previously issued license to obtain and file various types of claim bonds. A claim bond is a written guarantee from a surety that it will pay the bond's face value to discharge claims against the contractor. These bonds exist for the bene-

fit of: (1) homeowners who were damaged as a result of a contractor's work; (2) subcontractors or materialmen; (3) unpaid employees of the contractor; and (4) unions who are owed a portion of employees' benefits. Cal. Bus. & Prof. Code § 7071.10. Generally, claims against a contractor's bond must be made within two years after the expiration of his license. Cal. Bus. & Prof. Code § 7071.11.

License Bonds

To demonstrate financial responsibility, an applicant for a contractor's license must post a $12,500 license bond. Cal. Bus. & Prof. Code § 7071.6. Interestingly, the surety of the license bond is generally liable for only $7,500 in claims. The remaining $5,000 balance must be held for damage caused in connection with homeowners contracting for home improvement on their family residences. Cal. Bus. & Prof. Code § 7071.5.

Some contractors have difficulty procuring a license bond or would rather satisfy the condition with their own funds. For these persons, the law allows applicants to deposit cash or commensurate security with the Registrar. Cal. Code Regs. tit. 16 § 995.710 (2008).

Judgment Bonds

If the Board finds that a contractor's license applicant has failed or refused to pay a civil judgment, it will require him to post a judgment bond in an amount equal to the unsatisfied final judgment. Cal. Bus. & Prof. Code § 7071.17. The judgment bond must remain in effect for at least one year. *Id.* Thereafter, the requirement for the bond will be waived on submission of proof of satisfaction of all debts. *Id.*

Disciplinary Bonds

As referenced above, it is often the case that a previously licensed contractor must apply for a new license for a different business entity or for renewal or reinstatement of his license. If the contractor's license has been suspended or revoked in the past, the Board will require the applicant to post a disciplinary bond. Cal. Bus. & Prof. Code § 7071.8. The bond amount is decided by the Registrar of Contractors and is based upon the seriousness of the previous violation. *Id.* However, the sum shall not be less than $15,000 nor more than $125,000. *Id.* The disciplinary bond must remain in effect for at least two years. *Id.* The duration of the bond requirement is extended during periods when the license is not in good standing. *Id.* The Board will accept cash or some other qualified security in lieu of a disciplinary bond. Cal. Bus. & Prof. Code § 7071.12. If the contractor's license applicant does submit cash to satisfy the bond requirement, he is entitled to the interest the Board earns on his money. Cal. Code Regs. tit. 16 § 995.740 (2008).

Activities Requiring a License

As can be seen above, the definition of "contractor" is quite broad. *See* Cal. Bus. & Prof. Code § 7026. However, the licensing law is a contractor's main source for determining the activities he may legally undertake. Contractors are encouraged to familiarize themselves

with § 7026 and the sub-classification regulations. Unlicensed contractors face stiff penalties for performing work for which a contractor's license is required. Persons who are concerned that their business activity may require a contractor's license can request a written opinion on the subject from the Board. They may also look to case law, which generally provides that work that does not require a contractor's license will be deemed to require such license if any portion of the work falls within § 7026's definition of a "contractor."

Persons Who Need Not Be Licensed

Construction Employees

Any person who engages in construction work as an employee, receives wages as his sole compensation, does not customarily engage in an independently established business, and does not have the right to control the work is exempt from the contractor's license requirement. Cal. Bus. & Prof. Code § 7053.

Design Professionals

The Board does not require architects, engineers, licensed structural pest-control operators, geologists, and certified interior designers to obtain contractor's licenses. Cal. Bus. & Prof. Code §§ 5803, 7051.

Owner / Builders

An owner / builder is someone who owns property he desires to improve. Cal. Bus. & Prof. Code § 7044. To facilitate the improvements, he acts as his own general contractor and either does the work himself, has employees, or retains subcontractors. *Id.* To qualify as an owner / builder, a person must have actually lived at his property for 12 months prior to completion of the work. *Id.* Owner / builders are exempt from the contractor's license requirement. *Id.*

Material Suppliers

A person who sells and installs finished products that do not become a fixed part of a building need not obtain a contractor's license. Cal. Bus. & Prof. Code § 7045. Examples of such products include, cabinets, doors, clothes dryers, and dog runs. Material suppliers or manufacturers, who merely sell finished products that are attached to a building are not required to obtain a contractor's license. *Id.* However, persons who install home improvement goods, such as carpeting, fencing, air conditioning and heating equipment, spas, patios, awnings, and landscaping must possess a valid contractor's license. Cal. Bus. & Prof. Code §§ 7045, 7151.

Equipment Renters

Renters of construction equipment, such as forklifts, generators, welders, and tractors, are not required to be licensed because they do not add to, subtract from, or improve real property. *See Borello v. Eichler Homes, Inc.*, 221 Cal. App. 2d 487, 497-98 (Cal. Ct. App. 1st 1963).

Small Operations

Persons who perform construction work of a casual, minor, or inconsequential nature and charge less than $500 for labor and materials are not required to obtain contractor's licenses. Cal. Bus. & Prof. Code § 7048.

CONTRACTOR LICENSING LAW VIOLATIONS

The Legislature and Board have promulgated rules impacting classes of persons that perform construction work for money. The most stringent, and some say, Draconian penalties are imposed on unlicensed persons who perform work for which a contractor's license is required. However, *licensed* contractors who violate construction-related law are

also severely punished. The focus of these materials is exploring the consequences of performing construction work while unlicensed. Specifically, we detail California Business & Professions Code § 7031 and how its broad language gives rise to unfair outcomes. However, before we delve into § 7031, we must understand the ramifications of violating construction law while performing work as a licensed contractor.

Violations of Contractor Licensing Law When Licensed

The California Business & Professions Code sets forth various causes for discipline of a licensed contractor. These include the following: (1) work abandonment; (2) use of money designated for construction of a project for another purpose; (3) failure to pay subcontractors within 10 days of receipt of a progress payment; (4) willful departure from accepted trade standards or plans and specifications; and (5) violation of safety provisions in the California Labor Code, accompanied by death or serious injury. Cal. Bus. & Prof. Code §§ 7034, 7071.11, 7107, 7108, 7108.5, 7109, 7109.5, 7110, 7111, 7111.1, 7112, 7113.5, 7114, 7116, 7117.5, 7117.6, 7118.5, 7118.6, 7119, 7120; Cal. Civ. Code § 3097.

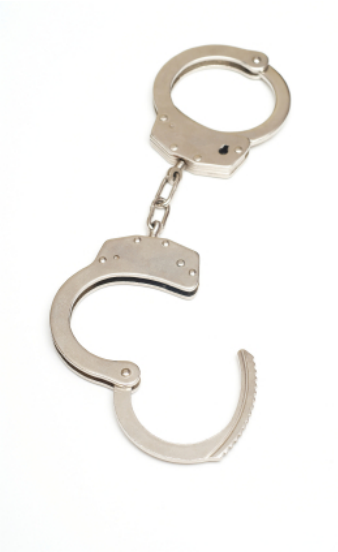
If a licensed contractor commits any of the above-listed violations, the Board may suspend, revoke, or refuse to issue a contractor's license. Cal. Bus. & Prof. Code §§ 7090, 7095. Violations of license law by licensed contractors may also give rise to bond claims and civil liability.

Violations of Contractor Licensing Law When Licensed

Criminal Penalties

"It is a misdemeanor for any person to engage in the business or act in the capacity of a contractor within this state without having a license therefor[.]" Cal. Bus. & Prof. Code § 7028. The Attorney General and county district attorneys are authorized to prosecute unlicensed contractors. Cal. Bus. & Prof. Code § 7028.2.

Unlicensed contractors face additional penalties pursuant to California Civil Procedure Code § 1029.8. Under this statute, a person, without a contractor's license, who injures or damages another person while providing goods or performing services for which a contractor's license is required is liable for treble damages. In its discretion, the court may award the injured



party attorney fees and costs. Fortunately for unlicensed contractors, the damages are capped at $10,000.

No California case law addresses the issue of whether the attorney fees are included in the damage limitation. Given the relatively small cap, however, it seems likely courts would exclude attorney fees in the cap. However, if you represent a contractor, no law precludes the argument that the discretionary attorney fees are capped, also. Further, the statute does not appear to address recovery of attorney fees where the defendant is merely vicariously liable for the conduct of another. Since attorney fees are discretionary, those representing a contractor facing vicarious liability should argue that the civil penalties are only applicable to

those who actually cause harm, not vicariously liable individuals.

Administrative Penalties

Injunctive Relief

B&P Code § 7028.3 allows the Registrar to seek an injunction against any person performing construction work while unlicensed. The unlicensed person may be prohibited from performing the work of a "contractor" as described in B&P Code § 7026.

Abatement Orders

In B&P Code § 7028.6, the Legislature empowered the Registrar to issue citations containing orders of abatement and civil penalties against persons acting in the capacity of a contractor without having a license in good standing. After investigation of an individual performing construction work without a license, the Registrar may issue a written citation to that person. Cal. Bus. & Prof. Code § 7028.7.

Labor Code Civil Fines

To discourage violations of the license law, the Legislature enacted a series of statutes creating civil penalties. Cal. Lab. Code §§ 1020-1024. These statutes provide that any person who does not hold a valid state contractor's license and employs workers to perform services for which a license is required, shall be subject to a civil penalty in the amount of $200 per employee for each day of employment. Cal. Lab. Code § 1021.

Labor Code Presumption That Contractor Is Employee

Another significant consequence of contracting with unlicensed individuals is the application of the evidentiary presumption set forth in California Labor Code § 2750.5. This statute provides in relevant part: "There is a rebuttable presumption affecting the burden of proof that a worker performing services for which a license is required, or who is performing such services for a person who is required to obtain such a license, is an employee rather than an independent contractor." Cal. Lab. Code § 2750.5. Later, § 2750.5 states in relevant part: "any person performing any function or activity for which a license is required shall hold a valid contractors' license as a condition of having independent contractor status." Cal. Lab. Code § 2750.5. The broad effects of this statute appear in three contexts.

Workers' Compensation

One consequence of § 2750.5 is that a person who retains an unlicensed contractor will be required to furnish workers' compensation benefits to the unlicensed contractor if he is injured on the job. Also, "Labor Code section 2750.5 operates to conclusively determine that a general contractor is the employer of not only its unlicensed subcontractors but also those employed by the unlicensed subcontractors." *Hunt Building Corp. v. Bernick*, 79 Cal. App. 4th 213, 220 (Cal. Ct. App. 4th 2000). Further, the hirer may be converted into an "employer," burdened with all the statutory requirements thereof. *See Fernandez v. Lawson*, 31 Cal. 4th 31, 38 (Cal. 2003) (concluding that whether Cal-OSHA applies to a homeowner depends on the nature of the services performed). Note that often unlicensed contractors seek to be classified not as employees entitled to workers' compensation benefits, but independent contractors unaffected by the California Labor Code § 3706's Exclusive Remedy rule. *See Furtado v. Shriefer*, 228 Cal. App. 3d 1608, 1617 (Cal. Ct. App. 1st 1991).

Vicarious Liability

The more dramatic effect of the § 2750.5 presumption was described in *Foss v. Anthony*

Industries, 139 Cal. App. 3d 794 (Cal. Ct. App. 4th 1983). In this case, Anthony Industries hired unlicensed contractor, Jo'Dee Enterprises, to excavate a swimming pool site. During the work, a Jo'Dee employee killed decedent Foss while driving a Jo'Dee truck. In subsequent litigation, Anthony moved for

summary judgment on the grounds that it could not be liable for Foss' damages because Jo'Dee was an independent contractor. The trial court granted the motion, finding that the § 2750.5 presumption only applied in workers' compensation cases. On review, the Court of Appeal reversed. It held that § 2750.5 applies in actions by third parties against the hirer of an unlicensed contractor regarding torts committed by the unlicensed contractor's employee. *Foss*, 139 Cal. App. 3d at 799; *See Fernandez v. Lawson*, 31 Cal. 4th 31, 41 n.3 (Cal. 2003). *See also* James Acret, *California Construction Law Manual* § 4:58 (CEB 2007) (stating "in addition to the other penalties suffered by a person who employs an unlicensed contractor, that person becomes liable for the wrongful acts, whether authorized or unauthorized, of the unlicensed contractor").

Significantly, it appears that § 2750.5 acts as a statutory override of express indemnity agreements and equitable indemnity rights. Thus, if one hires an unlicensed construction contractor and that contractor or its employee injures or damages another, the hirer is subject to vicarious liability in a later tort action. Vicarious liability makes a employer automatically liable for an employee's wrongful acts committed within the course and scope of employment, whether negligent or intentional. *Hinman v. Westinghouse Elec. Co.*, 2 Cal. 3d 956, 960 (Cal. 1970). Therefore, § 2750.5 has the effect of eliminating indemnity rights of the hirer against an unlicensed contractor.

Standing to Recover Payments

In *Fillmore v. Irvine*, 146 Cal. App. 3d 659 (Cal. Ct. App. 3d 1983), the court considered whether the § 2750.5 presumption could transform the legal status of an unlicensed drywall contractor to that of an "employee" exempt from the provisions of B&P § 7031. Because the purposes of the workers' compensation and licensing law statutory schemes differed greatly, the court held that the § 2750.5 presumption was inapplicable in the § 7031 context. Consequently, a person could be construed as an "employee" for workers' compensation purposes and an "unlicensed contractor" for § 7031 purposes

and be barred from recovering contractual payments.

BUSINESS & PROFESSIONS CODE § 7031

California Business & Professions Code § 7031 is a remarkable statute because it provides for marked unfairness as a means to discourage unlicensed contractors from performing construction work. It "represents a legislative determination that the importance of deterring unlicensed persons from engaging in the contracting business outweighs any harshness between the parties, and that such deterrence can best be realized by denying violators the right to maintain any action for compensation in the courts of the state." Lawrence Jennings Imel, *Substantial Compliance with the Contractors' State License Law: An Equitable Doctrine Producing Inequitable Results*, 34 Loy. L.A. L. Rev. 1539, 1545 (2001).

The statute establishes four separate rules relating to an unlicensed contractor's activities. Generally, subsections 7031(a) and (c) prohibit unlicensed contractors from recovering "compensation" or foreclosing a security interest on a given project. Subsection 7031(b) provides for "disgorgement," which in this context means payment by an unlicensed contractor of all money he received for construction work performed. Subsection 7031(d) discusses a contractor's burden to prove proper licensure. And subsection 7031(e) sets forth the narrowly construed "substantial compliance" exception to subsections (a) and (b). Because each of § 7031's subsections are detailed and provide for remarkable results, the following discusses each separately.

7031(a) & (c): Unlicensed Contractors May Not Recover "Compensation"

Subsection 7031(a) provides in relevant part:

Except as provided in subdivision (e), no person engaged in the business or acting in the capacity of a contractor, may bring or maintain any action, or recover in law or equity in any action, in any court of this state for the collection of compensation for the performance of any act or contract where a license is required by this chapter without alleging that he or she was a duly licensed contractor at all times during the performance of

that act or contract, regardless of the merits of the cause of action brought by the person[.]

This subsection purportedly advances the goal of public protection "by withholding judicial aid from those who seek compensation for unlicensed contract work." *Hydrotech Systems,* 52 Cal. 3d at 995. "The obvious statutory intent is to discourage persons who have failed to comply with the licensing law from offering or providing their unlicensed services for pay." *Id.* It applies "despite injustice to the unlicensed contractor" *Id.*

Additionally, § 7031(a)'s rule is strictly enforced. "[T]he cases are unanimous in holding that the courts may not resort to equitable considerations in defiance of section 7031." *Brown v. Solano County Business Development, Inc.*, 92 Cal. App. 3d 192, 198 (Cal. Ct. App. 1st 1979). However, such rigid enforcement of the rule yields astonishingly unfair results.

An example of such unfairness appears in the California Supreme Court case, *MW Erectors, Inc. v. Niederhauser Ornamental and Metal Works Co.*, 36 Cal. 4th 412 (Cal. 2005). Disney Corporation retained general contractor Turner to build a hotel. Turner subcontracted with Niederhauser to perform ornamental iron and structural steel work on the project. Niederhauser sub-subcontracted this work to MW Erectors in two separate contracts, one for structural steel and one for ornamental iron. MW began the structural steel work approximately 18 days before it was issued a C-51 structural steel specialty license. MW never obtained a C-23 ornamental iron specialty license.

After completion of the work, MW had not been paid $955,553 on the structural steel contract and $366,694 on the ornamental iron contract. It sued Niederhauser inter alia for recovery of these amounts. During subsequent litigation, Niederhauser moved for summary judgment on the ground that § 7031(a) prohibited MW from maintaining the action. The trial court granted the motion and dismissed MW's action in its entirety. On appeal, the court reversed. It found that since § 7031(a) required licensure during performance of the construction contract and MW had a C-51 license for a vast majority of the time it performed the structural steel work, MW could recover a large portion of its compensation on the structural steel contract.

The California Supreme Court reversed this decision, however. It examined relevant case law and determined that "one [who] fails to meet the technical requirements now set forth in section 7031(a) . . . is ineligible to recover any compensation under the terms of that statute, if, at ***any time*** during performance of an agreement for contractor services, he or she was not duly licensed. *MW Erectors*, 36 Cal. 4th at 425 (emphasis in original). As a result, MW lost over a million dollars because it was unlicensed for 18 days!

While no dispute exists that § 7031(a) and the *MW Erectors* decision serve to discourage unlicensed contractors from performing construction work, they also lead to several harmful consequences. For one, the law encourages work abandonment. Contractors, who experience short lapses in licensure, are motivated to abandon work, rather than complete it, because they face the very real possibility that the person who retained them will rely on § 7031(a) and not pay. The Supreme Court acknowledged this concern, but rejected it because

"Compensation"

Those sued by a contractor who was unlicensed for a period during performance of the work often raise the § 7031(a) defense without considering the nature of the relief sought. It is important to understand that the harsh consequences of § 7031 apply only to "compensation" for the "performance of any act or contract." Consequently, claims for breach of contract payment terms, quantum meruit, unjust enrichment, express indemnity, breach of written warranties, and foreclosure of mechanic's lien are barred. Pacific Custom Pools, Inc. v. Turner Constr. Co., 79 Cal. App. 4th 1254, 1266 (Cal. Ct. App. 2d 2000); Ranchwood Communities Ltd. Partnership v. Jim Beat Constr. Co., 49 Cal. App. 4th 1397, 1417 (Cal. Ct. App. 4th 1996). However, 7031(a) does not preclude negligence, equitable indemnity, breach of implied warranty of fitness, defective construction, and contribution claims. Ranchwood Communities, 49 Cal. App. 4th at 1420-21; Gaines v. Eastern Pacific, 136 Cal. App. 3d 679, 683 (Cal. Ct. App. 2d 1982).

the Court was unaware that this problem had surfaced. *MW Erectors*, 36 Cal. 4th at 430. Notwithstanding this sentiment, however, this problem does arise often. Unfortunately, lawyers advising contractor clients that do not have an "iron clad" "substantial compliance" case may consider recommending work abandonment to serve their clients' best interests.

The rule against unlicensed contractor recovery also encourages fraud. California courts hold that the no recovery rule applies even if the beneficiary of the unlicensed contractor's labors knew the contractor was unlicensed before execution of the contract. *Hydrotech Systems, Ltd.*, 52 Cal. 3d at 997; *MW Erectors, Inc.*, 36 Cal. 4th at 424. Consequently, a contractor who gains knowledge of a subcontractor's unlicensed status before a contract is executed or during performance of a contract may attempt to cheat the subcontractor of amounts due under the contract. Under the *MW Erectors* holding, there is no recourse for the unlicensed subcontractor. "Section 7031 places the risk of such bad faith squarely on the unlicensed contractor's shoulders." *MW Erectors*, 36 Cal. 4th at 444. "Knowing that they will receive no help from the courts and must trust completely to each other's good faith, the parties are less likely to enter an illegal arrangement in the first place." *Id.* But this rationale does not apply when a contractor commits no wrongful conduct and is unlicensed for only a short period of time. Regardless of the importance of a law's purpose, fraud should never be encouraged.

7031(b): Disgorgement

Subsection (b) of § 7031 provides: "Except as provided in subdivision (e), a person who utilizes the services of an unlicensed contractor may bring an action in any court of competent jurisdiction in this state to recover ***all compensation*** paid to the unlicensed contractor for performance of any act or contract." (emphasis added).

This subsection went into effect in 2002 and has elicited nothing but criticism from legal commentators since. *See, e.g.*, James Acret, *California Construction Contracts and Disputes,* § 1.79A (CEB 2007). Legal analysts agree that the rule is manifestly unfair and not narrowly-tailored to serve the license laws' purpose, viz. protection of the public from con-

tractor dishonesty and incompetence. It allows a person who hires a contractor to recover all money paid to the contractor if the contractor was unlicensed for a day. With courts' determination that § 7031's provisions will be strictly enforced, it does not matter whether the contractor purchased all the materials with his own funds. It does not matter whether the job was half-finished or complete. The statute clearly allows the hirer of a contractor unlicensed for only a day "to recover all compensation paid to the unlicensed contractor for performance of any act or contract."

Section 7031(b) disserves, and not protects, the public. Construction work is reviewed and approved by governmental inspectors. The threat of being denied contractual recovery does not encourage unlicensed contractors to comply with building and safety codes. Instead, the statute serves as a kind of "windfall" for hirers of unlicensed contractors. Those who acknowledge § 7031(b)'s unfairness are only comforted by the fact that the effects of its provisions are widely unknown.

In an apparent attempt to magnify the unfairness of the statute, California courts have uniformly held that the disgorgement remedy remains available even if the hirer of the unlicensed contractor knew he was unlicensed before the contract was executed or the work performed. Thus, California law sanctions the commission of fraud in pursuit of its goal to protect the public. Law with similar effects is unprecedented.

Under § 7031(b), a general contractor with knowledge that a roofing subcontractor has no license can take advantage of the subcontractor in three ways. First, he can state he knows the roofer is unlicensed in contractual negotiations and secure a better price than he could get from licensed roofers. Second, the general contractor can force the unlicensed subcontractor to make certain, possibly unfair, concessions during the work and threaten that if his terms are rejected, he will report the roofer to the Board. Third, once the work is complete, the general contractor can threaten to sue the roofer for disgorgement if other concessions are not accepted. If the roofer does not agree to the additional terms, the general contractor can sue and obtain disgorgement of all amounts paid. The Supreme Court's response to the general contractor's wrongful behavior? "Section 7031 places the risk of such bad faith squarely on the unlicensed contractor's shoulders." *MW Erectors*, 36 Cal. 4th at 444.

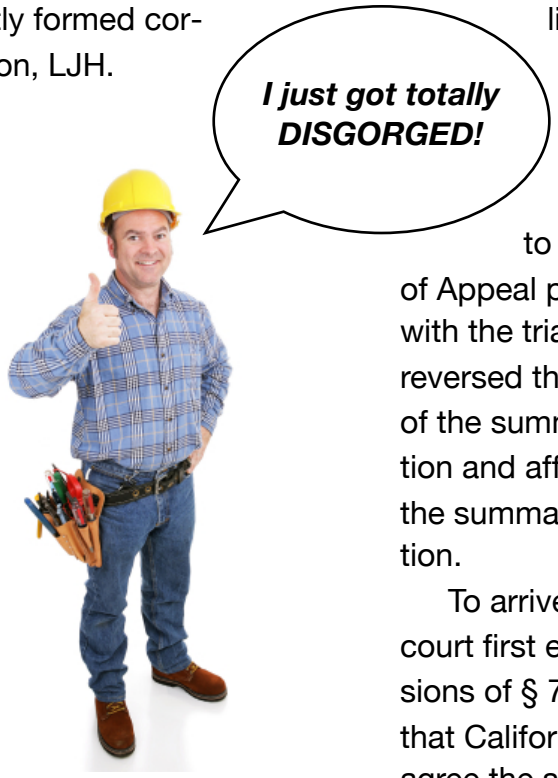
The problem with this belief is that it ignores the realities of "underground" construction work. Generally, subcontractors are not licensed because they want to be. Usually, a contractor is unlicensed because he cannot pass the exam, does not possess the requisite years of experience, or does not have enough money. These individuals are not rich -- they work projects for survival. Consequently, many unlicensed contractors deal with only those they trust, usually other contractors who know they are unlicensed. The threat of disgorgement will not deter them. If they are not paid on a project, they will not contract with the hirer again. Sometimes, to resolve the lack of payment, they resort to harmful behavior, including crime.

Encouragement of hirer bad faith also fails because many unlicensed contractors quickly use the money they make, either for personal income or other jobs. If a hirer sues them for disgorgement, the unlicensed contractor often has no

money to pay any judgment. As is discussed below, no insurance coverage exists for disgorgement. Thus, the hirer will either not sue or sue and obtain an uncollectible judgment. It is clear that the threat of bad faith conduct will not deter unlicensed contractors. Subsection 7031(b) does nothing but allow more sophisticated contractors to take advantage of other contractors who suffer momentary lapses in licensure.

As of this writing, no published California case on § 7031(b) currently exists. Two federal district court opinions discuss the statute, but do not provide guidance on its interpretation in subsequent cases. *See San Francisco Bay Area Rapid Transit Dist. v. Spencer*, 2007 WL 484861 (N.D. Cal. February 9, 2007); *Fru-Con Constr. Corp. v. Sacramento Muni. Util. Dist.*, 2007 WL 1791699 (E.D. Cal. June 15, 2007). The California Court of Appeal, however, has made available an unreported decision, *Bailey v. Kern County Sup. Ct.*, 2006 WL 3350777 (Cal. Ct. App. 5th 2006), which furnishes clues on how § 7031(b) may apply in the future.

This case involved plaintiff Bailey who entered into a $682,002.18 contract with Lyle Jensen Homes, Inc. ("LJH") on May 20, 2004 for construction of a residence. At this time, Lyle Jensen possessed a valid general contractor's license. However, his license had not been re-assigned to his recently formed corporation, LJH.



Performance of the contract began on July 28, 2004. LJH was duly licensed on August 30, 2004. After more than a year and after in excess of $500,000 was paid to LJH, Bailey became dissatisfied with the work and stopped paying. LJH sued Bailey. Bailey cross-complained and requested disgorgement pursuant to § 7031(b). He filed a motion for summary judgment on LJH's complaint and a motion for summary adjudication on the § 7031(b) claim in his cross-action. The trial court denied the motions, holding that since this case involved a mere re-assignment of a valid contractor's license and the licensure deficiency was rapidly cured, LJH did not constitute an "unlicensed contractor" subject to § 7031(b). The Court of Appeal partially disagreed with the trial court's decision. It reversed the trial court's denial of the summary judgment motion and affirmed its denial of the summary adjudication motion.

To arrive at its decision, the court first examined the provisions of § 7031(a). It observed that California courts uniformly agree the statute must be strictly construed. It noted the record did not contain evidence satisfying the elements of the "substantial compliance" exception of § 7031(e). The court then held that since LJH was unlicensed for approximately one month during performance of the work, it had no standing to recover contractual compensation pursuant to § 7031(a).

The appellate court then turned to Bailey's summary adjudication motion. It reviewed the words of § 7031(b) carefully. Bailey cited *MW Erectors* and argued the decision meant that the hirer of a contractor, who was at anytime unlicensed during performance of the contract, could recover everything paid to the contractor. The Court of Appeal did not find, "anything in *MW Erectors, Inc.* which states that a contractor is precluded from retaining compensation paid to the contractor for work done while the contractor was licensed if the contractor also happened to perform some work while unlicensed." *Bailey*, 2006 WL 3350777 at 7. It held that *MW Erectors* "did not construe the meaning of subdivision (b)." *Id.* The court went on to state that it could find nothing in the legislative history of § 7031 that would compel it to "conclude that subdivision (b) was intended to permit a person to recover compensation paid to a licensed contractor for work done by the licensed contractor, merely because the person may also have paid for some unlicensed work as well." *Id.* at 9. The significance of this opinion is the court's apparent view that § 7031(b) requires disgorgement of only money paid for construction work performed while the contractor was technically unlicensed. It appears the court affirmed the trial's court's denial of summary adjudication because it found triable issues concerning what amounts Bailey paid for unlicensed work.

Although the *Bailey* opinion is available for our review, it may not be cited in legal proceedings, and therefore, cannot function as precedent in future cases. However, its reasoning is sound. By veiled reference to the case, our firm has been successful in having trial courts adopt its reasoning. The California Legislature's apparent strong beliefs on deterring unlicensed construction work clash with the blatant unfairness of § 7031(b). We believe the *Bailey* decision presents a workable compromise for both proponents and opponents of § 7031(b). Therefore, we will continue to urge that the *Bailey* rationale be codified in California.

7031(d): Proof of Licensure

The provisions of this subsection are straight-forward. In substance, they allow a contractor to prove licensed status by producing a verified certificate of licensure from the Board. Section 7031(d) places the burden of proof of licensure at all times on the contractor.

7031(e): "Substantial Compliance"

Section 7031 was enacted by the California Legislature in 1939 along with a majority of the provisions in current contractor's licensing law. Cal. Bus. & Prof. Code § 7031; Imel, *supra*, 34 Loy. L.A. L. Rev. at 1543. Seven years after the statute went into effect, the Supreme Court recognized inequities that would result from strict enforcement of its provisions. *Id.* at 1546. *See Gatti v. Highland Park Builders*, 27 Cal. 2d 687, 690 (Cal. 1946). Twenty years passed, and in *Latipac*, Inc. v. Sup. Ct., 64 Cal. 2d 278, 281 (Cal. 1966), the Supreme Court set forth requirements for a judicial doctrine of "substantial compliance." Under the doctrine, a contractor, unlicensed for a period during performance of construction work, could recover contractual compensation if he could prove: "(1) the fact that [the contractor] held a valid license at the time of contracting, (2) that [the contractor] readily secured a renewal of that license and (3) that the responsibility and competence of [the contractor's] managing officer were officially con-

firmed throughout the period of performance of the contract." *Latipac*, 64 Cal. 2d at 281.

Throughout the 70's and 80's, California courts applied the substantial compliance doctrine liberally. Eventually, however, the Legislature halted repeated application of the judicially-made exception. The Legislature enacted § 7031(d), which in 1991, became § 7031(e). It currently provides: The judicial doctrine of substantial compliance shall not apply under this section where the person who engaged in the business or acted in the capacity of a contractor has never been a duly licensed contractor in this state. However, notwithstanding subdivision (b) of Section 143, the court may determine that there has been substantial compliance with licensure requirements under this section if it is shown at an evidentiary hearing that the person who engaged in the business or acted in the capacity of a contractor (1) had been duly licensed as a contractor in this state prior to the performance of the act or contract, (2) acted reasonably and in good faith to maintain proper licensure, (3) did not know or reasonably should not have known that he or she was not duly licensed when performance of the act or contract commenced, and (4) acted promptly and in good faith to reinstate his license upon learning it was invalid.

This exception to the provisions of §§ 7031(a) and 7031(b) is interpreted narrowly. Thus, an inadvertent clerical error or negligent failure to confirm licensure does not constitute substantial compliance, and the contractor may not take advantage of the exception. Imel, *supra*, 34 Loy. L.A. L. Rev. at 1555. *See also Pacific Custom Pools, Inc. v. Turner Constr. Co.*, 79 Cal. App. 1254, 1265 (Cal. Ct. App. 2d 2000).

COVERAGE AND LITIGATION OF § 7031 CLAIMS

Up until recently, those who took issue with a contractor's quality of work would sue for breach of contract, negligence, and related causes of action. At present, however, with the broad effects of § 7031 becoming more widely known, plaintiffs are including § 7031(b) claims in their defective construction actions, regardless of whether they have any information about the lapsing of their contractor's license. No additional costs are associated with maintaining such a cause of action. The defendant contractor has the burden of proving proper licensure. Cal. Bus. & Prof. Code § 7031(d). As many contractors will attest, lapses in licensure often occur through mistake. And the benefits of catching a contractor with a non-renewed license during performance of the work are extraordinary -- FREE WORK!

Since most of these new § 7031(b) actions also include allegations of accidental property damage, defense counsel and claims professionals will confront the issue of whether an action including a request for § 7031(b) disgorgement is potentially covered by a particular CGL policy. They will face insured pressure to pay more for settlement to avoid substantial personal liability. Further, they will often have the "delightful" experience of working closely

with the insured's *Cumis* counsel. The following discusses the discrete coverage and claims handling issues accompanying cases with § 7031(b) claims. The text also suggests recommendations for successfully handling the defense of disgorgement claims.

Is Disgorgement Covered?

Let's review the basics. Generally, CGL policies cover "bodily injury" and "property damage" caused during the policy period by an "occurrence." *See Frontier Oil Corp. v. RLI Ins. Co.*, 153 Cal. App. 4th 1436, 1443 (Cal. Ct. App. 2d 2007). Usually, "bodily injury" is defined as "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time," and "property damage" means "physical injury to tangible property, including all resulting loss of use of that property" and "loss of use of tangible property that is not physically injured." *See Golden Eagle Ins. Corp. v. CenFed, Ltd.*, 148 Cal. App. 4th 976, 986 (Cal. Ct. App. 2d 2007); *Aim Insurance Co. v. Culcasi*, 229 Cal. App. 3d 209, 220 (Cal. Ct. App. 6th 1991). Policies generally define an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." *See Merced Mutual Ins. Co. v. Mendez*, 213 Cal. App. 3d 41, 44 (Cal. Ct. App. 5th 1989). Consequently, accidental bodily injury or property damage during the effective dates of the policy can give rise to coverage, if not otherwise excluded. Subsection 7031(b) disgorgement is not property damage, and is certainly not bodily injury. Disgorgement is an equitable remedy. Equitable remedies are generally not covered by CGL policies. *Jaffe v. Cranford Ins. Co.*, 168 Cal. App. 3d 930, 935 (Cal. Ct. App. 4th 1985). Consequently, claims for § 7031(b) disgorgement are not covered by CGL policies.

However, complaints including disgorgement causes of action often contain facts giving rise to a "potential for coverage." Whenever an action against the insured seeks damages on any theory that, if proved, would be covered by the policy, a potential for coverage is present, and the insurer owes a duty to defend. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 275 n.15 (Cal. 1966). Of course, the presence of a disgorgement claim does not affect the scope of the insurer's duty to defend. If allegations supporting a potential for coverage are pled, insurers have a duty to defend all claims presented in the action, including disgorgement claims. *Buss v. Sup. Ct.*, 16 Cal. 4th 35, 48 (Cal. 1997). Therefore, even though § 7031(b) disgorgement claims are not covered, often insurers must defend them because plaintiffs have alleged facts giving rise to bodily injury and / or property damage taking place during the policy period.

Successfully Discharging the Duty to Defend

Reservation of Rights

If the claims professional determines a potential for coverage is present in an action alleging disgorgement, timely issu-

ance of a reservation of rights letter is absolutely required. A reservation of rights letter notifies the insured of the insurer's intent to defend. It also warns the insured that the insurer reserves its rights to refuse to indemnify against any judgment and to withdraw its defense upon the same ground. *See Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489, 497-98 (Cal. 2001). Generally, failure to provide an insured with a reservation of rights letter when the insurer contends at least portions of the claim are not covered or are excluded generally results in waiver of coverage defenses. *Id.* at 498. A claims professional must not neglect to issue a reservations of rights letter when a § 7031(b) is made. The insurer could be held liable for the entirety of the claim.

Contractor Coverage Counsel

If you are a contractor who has been sued for disgorgement, you should secure competent insurance coverage counsel, if at all possible. If a potential for coverage is found, your insurer will appoint defense counsel. Defense counsel will likely be able to perform satisfactorily in working to counter plaintiff's allegations. However, he will be of no assistance in negotiating with your insurer on allegedly uncovered or excluded claims, including disgorgement. The scope of defense counsel's obligation to the contractor is limited to defending him in the suit maintained by the plaintiff. *Foster Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 18 Cal. 4th 857, 878-79 (Cal. 1998). Defense counsel should not represent the contractor in coverage negotiations. However, such negotiations are crucial, and the contractor should retain a knowledgeable attorney to actively participate in them.

Crazy Cumis Counsel!

Insurer Coverage Counsel

Depending on the estimated value of plaintiff's claim and complexity of the coverage issues presented, insurers may decide to retain their own coverage counsel in an action including a § 7031(b) cause of action. Although claims professionals have every right to handle negotiations with the insured when disgorgement is alleged, it may reduce emotional tension and lead to a more efficient resolution of the claim if coverage counsel is retained. An insurer's counsel could be tasked with drafting the reservation of rights letter, monitoring the litigation, handling insured coverage inquiries, and being present at mediations and other settlement negotiations. When the insurer has to take tough stances on coverage, an insurer's coverage counsel, who may be more familiar with the legal principles at issue, may diffuse emotional conflicts and limit the rhetoric so that a reasonable resolution of the matter can be attained.

Cumis Counsel

California Civil Code § 2860(b) obligates the insurer to furnish independent counsel to the insured if it provided the defense subject to a reservation of

rights and the outcome of the coverage dispute can be affected by the manner in which the case is defended. Often in cases in which disgorgement is alleged, plaintiff alleges the construction varied from the contract, plans, and specifications and violated the applicable standards of care. Usually, this complaint is segregated into breach of contract and negligence claims. However, many of the specific defective construction claims overlap. For example, installation of PVC instead of copper plumbing pipes may be construed as either a breach of contract or negligence. If construed as a breach of contract claim, it is obviously not covered. However, if construed as a negligence claim, it may be covered. *See Armstrong World Industries, Inc. v. Aetna Cas. & Sur. Co.*, 45 Cal. App. 4th 1, 91-93 (Cal. Ct. App. 1st 1996) (holding that where defective work or materials must be removed or repaired to comply with building codes or health and safety standards, its presence constitutes "physical injury" to the building). If defense counsel, in protecting the interests of the insured during litigation, determines that he has the ability to control the outcome of a coverage dispute such as the one presented above, he is duty-bound to disclose the potential conflict in writing to both the insured and the insurance company and obtain informed written consent from the insured before continuing the representation. Cal. R. of Prof. Conduct 3-310.

Using § 7031 Defensively

Section 7031 can be asserted defensively in two ways. Most commonly, owners or contractors use § 7031(a) to stave off subcontractor claims that progress or retention payments were not made. Under § 7031(a) and current case law, if the subcontractor was unlicensed for a day during work performance, he has no standing to sue for breach of contract or mechanic's lien foreclosure. Further, his hirer may be entitled to recoup all compensation paid pursuant to § 7031(b).

Increasingly, lawyers involved in construction litigation are seeing the statute used defensively in another manner. If a subcontractor has knowledge that the owner, general contractor, or subcontractor who hired him was unlicensed during the work, he may demurrer to or move for summary judgment on the breach of contract, express indemnity, and breach of warranty claims involved in the litigation. As discussed above, unlicensed persons may not recover on such causes of action under § 7031(a).

Often, the consequences of using § 7031 in this manner are significant. For instance, our firm was involved in one case in which a residential owner sued our client, the general contractor, for defective construction. It was undisputed our client was unlicensed for short periods during construction. Our client's contract did not require his subcontractors to name him as an additional insured, and as a consequence, the subcontractors did not provide AIEs. On behalf of our client, we cross-complained against the subcontractors for breach of contract, express indemnity, and breach of warranties, inter alia. During the litigation, the court dismissed these causes of action because of our client's unlicensed status. Without the benefit of the express indemnity agreement and any AIEs, our client was not entitled to a defense by the subcontractors. Additionally, our client faced liability for both his active and passive negligence. After the applicability of § 7031(a) was

asserted, our client went from a position of power in the case to just another alleged tortfeasor.

To take advantage of the defensive uses of § 7031, we recommend claims professionals, defense counsel, or contractors obtain Certified License History documents from the Board for every contractor against whom the insured maintains a claim and every contractor maintaining a claim against the insured. The "Request for Certified License History or Certificate of Non-License" is available at the Board's website, www.cslb.ca.gov. The fee is $67.00, but the potential results are well worth the price. Obtaining such a license history will assist in discovering periods during which work was performed and the contractor was unlicensed. The information provided by the license history may be used to elicit written discovery responses or answers to deposition questions. And if you discover a contractor was unlicensed, you have a trump card in the litigation.

Section 7031 & Summary Judgment

Motions for Summary Judgment

Enthused by the discovery that their subcontractor was unlicensed during the work, plaintiffs may consider summary judgment as a more rapid means of obtaining a greater recovery than they could have attained under their other causes of action. However, plaintiffs are not advised to move for summary judgment on the ground that no material dispute exists that they entitled to judgment on a § 7031(b) disgorgement claim. Even if the motion is successful, plaintiffs may wind up with an entirely uncovered judgment from an insolvent unlicensed contractor.

Summary Adjudication Motions

Plaintiffs who maintain a disgorgement claim against a contractor sometimes move for summary adjudication of any defense to disgorgement to obtain an advantage in settlement negotiations. Unfortunately for them, however, these motions rarely succeed. Usually, the trial court seizes on one of two rationales. If it adopts the *Bailey* court's reasoning, then the defendant has a defense to complete disgorgement. Even if it does not, triable issues as to the amounts paid often arise (e.g., Owner: "I paid $50,000," Contractor: "He paid me $48,000.").

Defendants sued by contractors unlicensed during the work may properly invoke summary adjudication procedure to excise causes of action on which recovery is barred by § 7031(a). At the outset of litigation, it is recommended that defendant contractors determine whether plaintiff was licensed during the work. If he was not, the contractor should promptly move for summary adjudication to obtain an advantage in the litigation.

Opposing Summary Judgment or Summary Adjudication Motions

Faced with a summary judgment or summary adjudication motion, an unlicensed contractor should argue that the reasoning of *Bailey* must be adopted by the trial court. As discussed above, the *Bailey* court found nothing in the legislative history or case law that forces courts to require a contractor, unlicensed for periods during construction, to disgorgement all that was paid to him. It appeared to approve the proposition that § 7031(b) requires disgorgement of only money paid for construction work performed while the contractor was unlicensed. The rationale of the *Bailey* court is attractive because its application begets reasonable and equitable results. Hopefully, the de-

fendant unlicensed contractor can convince the court that, after application of the *Bailey* reasoning, triable issues exist with respect to the amount of disgorgement owed.

Settlement

If the allegations of plaintiff's disgorgement action create a potential for coverage, the insurer owes a duty to defend. Incorporated in this defense obligation is the duty to settle, *viz*. accept reasonable settlement demands within policy limits in order to avoid exposing the insured to personal liability in excess of those limits. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659 (Cal. 1958).

Often in daily practice, the plaintiff's settlement demand does not exceed the applicable policies' limits. So, the question about whether the refusal to settle has "opened up" or "popped" the policy does not arise. *See Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 15-16 (Cal. 1975). Many times in these situations, the demand for repair costs, loss of use, and incidental damages combined with the disgorgement are much higher than the insurer's estimation of potentially covered damages. Because disgorgement is an equitable remedy, personal to the unlicensed contractor, the insured cannot pawn off any liability to each of the subcontractors under equitable indemnity principles. Therefore, if the case is going to settle, the insurer faces the prospect of insured personal contribution.

An insurer should have coverage counsel on hand to request personal contribution to settlement of an action including disgorgement claims. In California, an insurer may be liable "for unreasonably coercing an insured to contribute to a settlement fund, even though (by definition) there is no 'excess judgment' where a case is settled." *J.B. Aguerre, Inc. v. Amer. Guar. & Liab. Ins. Co.*, 59 Cal. App. 4th 6, 15 (Cal. Ct. App. 2d 1998). It appears the *J.B. Aguerre* court used the phrase "unreasonable coercion" to distinguish from "garden variety" coercion. However, in most circumstances in which the prospect of insured personal contribution arises, strong persuasion is present. A common scenario involves an insurer's ultimatum that it will pay no more than a percentage of a plaintiff's demand within policy limits because of coverage defenses. The insured is then presented with the opportunity to pay the remaining percentage of the settlement or face trial and disgorgement liability. Whether the insurer in this situation unreasonably coerced the insured is anybody's guess. However, if you are an insurer, you really do not want to pay your lawyers to find out.

The best case scenario when parties attend mediation of an action in which § 7031(b) disgorgement is alleged includes the insured being represented by defense and personal counsel and the insurer being represented by coverage counsel. Defense counsel can discharge his obligation to obtain a reduced demand. Personal and insurer coverage counsel can negotiate what portions of any reasonable settlement will be paid by which parties. In no case in which uncovered or disgorgement claims are alleged should defense counsel request that the insured personally contribute to the settlement. Is such a request per se bad faith? No. But the insurer would likely incur such substantial costs proving defense counsel's request did not constitute unreasonable coercion that having the parties separately represented for liability and coverage issues is only prudent.

In the absence of an insured's personal or *Cumis* counsel, the insurer's coverage counsel should present a personal contribution request to the insured directly. Such a request should be given in writing before the mediation. It should be confirmed in writing after the mediation. If the insurer has no coverage counsel but seeks a personal contribution from the insured for settlement, such a request should come from the claims professional. Defense counsel faced with a request from the insured for advice on whether he should contribute personally, should assist the insured in obtaining an opinion from independent counsel.

CONCLUSION

You ask: "What about the five easy steps to a free remodel?" Well, if you have not already figured them out, they are: (1) get remodel construction plans; (2) identify local contractors; (3) investigate which of these is unlicensed; (4) hire an unlicensed contractor to construct the remodel; and (5) sue the unlicensed contractor at the end of the project for disgorgement under B&P Code § 7031. ***It's that easy!***

The above paragraph is written in jest, of course. After reviewing the above, you know that it is ***not*** that easy. Those asserting § 7031 claims must be familiar with the many provisions of California licensing law and be cognizant of the various coverage questions involved. However, it cannot be denied that § 7031 is an extraordinary law. No other law provides for such unfairness to discourage unlicensed activities. Having completed your review of these materials, you might even join us in advocating for change of the statute and adoption of the *Bailey* court's rationale. That is, unless you're a homeowner in dire need of a free remodel . . .