

MEMORANDUM

TO: [REDACTED]
[REDACTED], and [REDACTED]

FROM: [REDACTED], Esq.

RE: [REDACTED] Contract Recovery Matter

DATE: November 1, 2005

This Memorandum is presented pursuant to your request of October 31, 2005.

FACTS

Our client is [REDACTED] Inc., a corporation wholly owned by [REDACTED]. Mr. [REDACTED] is an officer, a director, and the (sole?) shareholder. The company installs alarm systems in homes and then has contracts with the customer to monitor the alarms.

[REDACTED] originally did business under the fictitious business name of [REDACTED] Alarm Systems” as a sole proprietor. This proprietorship held a contractor’s license with a comparatively low number, indicating that the firm had been in business for a long time.

Mr. [REDACTED] incorporated his proprietorship several years ago. When he contacted the licensing authority, he was told that the corporation would need to obtain a new license with a new number; the new number would be much higher than the old proprietorship’s number, thus losing the advantage of appearing to have been in business for a long time. Presumably as a result of his desire to preserve the appearance of longevity represented by the old license number, Mr. [REDACTED] did not obtain a new license for the corporation. The corporation has been doing business under the former fictitious business name and relying upon the old license originally procured by the proprietorship.

The corporation has recently filed a fictitious business name statement and thereby registered the name “[REDACTED] Alarm Systems” as a “dba.” A customer of the corporation has refused to pay a bill owed the company and the customer’s counsel is contending that because the corporation itself is unlicensed, it is precluded from collecting in return for services rendered and work performed.

ISSUE

Can the company expect to prevail if it sues the customer to enforce its contract and collect its fees? If success in such a lawsuit appears unlikely, how can we remedy the situation to get around the problem?

OTHER PERTINENT NOTES

1. The Starting Point for Research of the “Substantial Compliance” Doctrine.

You have observed that it is your understanding and belief that an unlicensed contractor cannot sue to collect for his work. You have also mentioned that “Here we have possible substantial compliance as the individual owns the corporation and the individual is licensed and puts his license number on the corporation’s contracts.” Your second e-mail also points out that “The research starts with B&P section 7031 substantial compliance and the difference between the individual being the licensee and his wholly owned corp doing work without actually transferring [the] license into the name of the corp.”

2. The Law Surrounding “Substantial Compliance.”

Prior to 1992, there were several California cases which dealt with fact situations very similar to that presented in your e-mails. In these instances it was routinely held that if an unlicensed corporation was the employer of a licensed “managing general agent” or similar type of employee, the corporation itself could be said to be in “substantial compliance” with the California licensing statutes. But in the aftermath of this line of cases the California Legislature chose to act by specifically describing via statute exactly what would and would not qualify as “substantial compliance.” And unfortunately, in your factual scenario, your clients appear to fall squarely outside the safe harbor provisions that the Legislature did enact.

SUMMARY OF CONCLUSIONS

At first glance, this fact situation appears untenable in the face of both California’s statutory provisions precluding recovery by unlicensed contractors as well as by a large body of case law emphasizing that protection of the public against the perils presented by unlicensed persons performing contracting work is of such paramount importance that it trumps traditional alternative routes to recovery such as unjust enrichment, estoppel, and other equitable remedies.¹

¹ There are at least 36 separate reported cases in California which are characterized as being “modern” cases dealing with the question indicated as being the subject of the Annotation at 44 A.L.R.4th 271, “Failure of Building and Construction Artisan or Contractor to Procure Business or Occupational License as Affecting Enforceability of Contract or Right of Recovery for Work Done – Modern Cases.” A list of these 36 cases is set forth in Appendix “A” to this Memorandum for the reader’s ease of reference and as a further research tool. Besides the “modern” cases, other, older cases having a bearing on the issues addressed in this Memorandum are also set forth in the text which follows.

Then, beginning in a line of cases that originated in 1966 and culminated in 1992, good news began to appear on the horizon. Even in the face of a very hostile statutory scheme, the courts dealt specifically with fact situations nearly identical to the one you have posed, and allowed unlicensed corporations to recover under their contracts based on the holding by their principals of valid licenses. It was a very narrow exception to the almost overwhelming general rule, but it was a supportable exception nonetheless and one that applied squarely to the situation now confronted by [REDACTED] Alarm Systems Inc. and Mr. [REDACTED].

Unfortunately, the validity of the arguments advanced by this line of cases has subsequently been called into serious question because following the last such case in 1992, the Legislature acted to amend *Business & Professions Code* Section 7031 by adding language that appears to wipe out the exceptions that the 1966-1992 cases had created.

Short Version of the Conclusion: The balance of this Memorandum analyzes applicable California law and concludes that *while [REDACTED] Alarm Systems Inc. can probably not overcome the statutory bar imposed by Business & Professions Code §7031 as it is presently worded, it may nevertheless be able to circumvent the impact of the statute by assigning its claim to a third party and allowing that third party to bring suit against the customer.*

DISCUSSION

1. Preliminary Question: Was the Nature of the Work That Was the Subject of [REDACTED] Alarm Systems Inc.’s Contract With Its Customer Such That a License Was Statutorily Required?

The fact situation described in your first e-mail indicates that “It [the corporation] installs alarm systems in homes and then has contracts with the customer to monitor the alarms.” It thus appears that there are really two separate sets of contractual arrangements involved. The first covers the installation of the alarm systems; the second provides for [REDACTED] Alarm Systems Inc.’s services in monitoring the alarms on an ongoing basis.

The distinction could be important because while the first contractual arrangement almost definitely requires the contractor to hold a valid contracting license, the second arrangement probably does not.

An early case now more than fifty years old held that one who undertakes, or offers to undertake, to submit a bid to construct, alter, repair, add to, subtract from, improve, move, wreck, or demolish any building is a “contractor” within California’s then-existing statutory provisions regulating the licensing of contractors. *Albaugh v. Moss Const. Co.* (App. 1 Dist.. 1954) 125 Cal.App.2d 126, 269 P.2d 936. The definition has not materially changed over the years; in *Vallejo Development Co. v. Beck Development Co.* (App. 1 Dist.. 1994) 24 Cal.App.4th 929, 29 Cal.Rptr.2d 669, *rev. den.*, the court held that a “contractor” for purposes of the licensing statute is someone who has a direct contractual relationship with the owner of real property who agrees to provide both labor and materials for the improvement of that property.

It would thus seem that while the installation of the alarm systems by [REDACTED] Alarm Systems Inc. is undoubtedly something for which a contractor's license would be required, the subsequent monitoring services do not appear to fall within the purview of the statutory scheme.² In *Wilson v. Steele* (App. 2 Dist.. 1989) 211 Cal.App.3d 1053, 259 Cal.Rptr. 851, *modified*, the court held that a contractor's entitlement to enforce payment under a contract is dependent upon the nature of the performance, rather than on the contractor's licensure status, and that the licensing requirement only extends to contracts for which a license is required by statute. This same principle was phrased another way in *Ranchwood Communities Limited Partnership v. Jim Beat Construction Co.* (App. 4 Dist.. 1996) 49 Cal.App.4th 1397, 57 Cal.Rptr.2d 386, *reh. den.*, in which it was held that where an unlicensed contractor is also a party to a separate contract with its customer, the lack of a license will not bar the obtaining of recovery for breach of the second, separate contract.

Along similar lines, the court in *American Sheet Metal, Inc. v. Em-Kay Engineering Co.* (1979 E.D. Cal.) 478 F.Supp. 809 (applying California law) held that although an unlicensed contractor could not bring an action on a contract for which a license was required under the statute expressly precluding such an action, the contractor was not precluded under the statute from suing on a contract which was separate from that for which a license was required. Construing *Business & Professions Code* Section 7031 as prohibiting a contractor from maintaining an action for the collection of compensation for the performance of any act or contract for which a license was required, the court nevertheless ruled that a counterclaim of an unlicensed general contractor against a subcontractor for damages suffered due to the subcontractor's nonperformance on a contract to supply and install machinery which became a permanent fixture of a manufacturing plant was not on the contract for which the contractor was unlicensed and was therefore not barred under the statute.

Under the facts as presented in our present situation, even if [REDACTED] Alarm Systems Inc. is precluded from recovering under its contract to install the alarm system, that preclusion

² *California Administrative Code* Title 16, §832.28 covers "Class C-28 Lock and Security Equipment Contractor[s]." Its parameters presumably cover the activities in which [REDACTED] Alarm Systems Inc. engages, at least when it *installs* (though not when it thereafter *monitors*) its security systems for customers. The specific definition provides: "A lock and security equipment contractor evaluates, sets-up, installs, maintains and repairs all doors and door assemblies, gates, locks and locking devices, panic and fire rated exit devices, manual and automatic operated gate and door closures and releases, jail and prison locking devices and permanently installed or built in safes and vaults. This classification includes but is not limited to master key systems, metal window guards, security doors, card activated and electronic access control systems for control equipment, motion and other types of detectors and computer systems for control and audit of control systems and other associated equipment. Fire alarm systems are specifically not included in this section."

will not likely extend to the second set of contractual arrangements under which it will provide monitoring services.³

The balance of this Memorandum treats the two contracts as being collectively a single arrangement for ease of reference.

2. Summary of the General Rule.

As summarized by one commentator, the general rule itself is not favorable when applied to ██████████ Alarm Systems Inc.'s and Mr. ██████████'s situation. According to 44 A.L.R.^{4th} 271, "Failure of Building and Construction Artisan or Contractor to Procure Business or Occupational License as Affecting Enforceability of Contract or Right of Recovery for Work Done – Modern Cases," §2[a]:

"The question whether an unlicensed artisan or construction contractor may enforce or recover upon his contract is primarily determined by the provisions of the particular licensing statute or ordinance involved. Under statutes or ordinances expressly providing that the contract of an unlicensed artisan or construction contractor cannot be enforced, or that an action for the collection of compensation cannot be maintained, unless the artisan or contractor establishes that he was duly licensed, it has generally been accepted that an unlicensed person cannot bring or maintain an action on his contract."

But there is an equally well-recognized potential exception to the general rule that may offer some relief from the harsher consequences of the generalized summary set forth above. Specifically, unlicensed contractors who have nonetheless "substantially complied" with the applicable licensing requirement may still be afforded a remedy against customers who refuse to pay in reliance upon the non-fulfillment of the licensing requirement. As summarized in 13 Am. Jur. 2d, "Building and Construction Contracts," "VII. Regulation of Contractor's Business," "B. Effect of Licensing Statute on Contract by Unlicensed Contractor," §133 ("Substantial compliance with licensing statute"):

"In some jurisdictions, under a statute that bars unlicensed contractors or artisans from maintaining actions for compensation or for work done on contracts for which a license is required, a

³ I bring up this distinction because I have been the "customer" under two separate home alarm system contracts, and each time experienced a scenario that I understand is basically the "standard of the industry." In each instance, the fee for installing the system hardware was fairly nominal, and was used as a basis for getting the contractor's proverbial foot in the door in order to reap the more profitable, and ongoing, monthly fees for alarm monitoring services. Whether this is the case regarding ██████████ Alarm Systems Inc. is something the facts do not disclose; but if it is, an inability to recover on the first contract may not be as disastrous as it might otherwise seem provided that recovery can be achieved on the second contract.

contractor or artisan cannot recover under the contract when he or she was not properly licensed at the time the contract was entered into or during its performance. [Footnote omitted] *However, other courts hold that a contractor or artisan may maintain an action on a contract for which a license was required, despite a statute expressly prohibiting the maintenance of such an action, when, although the contractor or artisan was not licensed throughout the period of the contract, there was substantial compliance with the licensing statute.* [Footnote omitted] [Emphasis added]

It has been held under such a statute that an unlicensed corporation or partnership is not entitled to recover on the contract, even though a corporate officer or a partner was properly licensed. [Footnote omitted] *However, it has also been held that an unlicensed contractor or artisan can recover on his or her contract when the contract was entered into or the work was performed in conjunction with a person or entity who was licensed.* [Footnote omitted]” [Emphasis added]

But that is where the potentially bright side of the States’ general rule’s potential exception ends, when it runs straight into the face of California’s specific statutory scheme.

3. California’s “Substantial Compliance” Statutory Provision.

As noted in your second e-mail, *Business & Professions Code* §7031 is indeed the starting point for research into the substantial compliance issue. That section, which in general supports your “...understanding and belief that an unlicensed contractor cannot sue to collect for his work,” provides as follows:

“§ 7031. Unlicensed contractors prohibited from bringing or maintaining action to recover compensation in any court in state; recovery by person utilizing unlicensed contractor

(a) 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, except that this prohibition shall not apply to contractors who are each individually licensed under this chapter but who fail to comply with Section 7029.*

(b) 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.

(c) A security interest taken to secure any payment for the performance of any act or contract for which a license is required by this chapter is unenforceable if the person performing the act or contract was not a duly licensed contractor at all times during the performance of the act or contract.

(d) If licensure or proper licensure is controverted, then proof of licensure pursuant to this section shall be made by production of a verified certificate of licensure from the Contractors' State License Board which establishes that the individual or entity bringing the action was duly licensed in the proper classification of contractors at all times during the performance of any act or contract covered by the action. Nothing in this subdivision shall require any person or entity controverting licensure or proper licensure to produce a verified certificate. When licensure or proper licensure is controverted, the burden of proof to establish licensure or proper licensure shall be on the licensee.

(e) 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 or her license upon learning it was invalid.

(f) The exceptions to the prohibition against the application of the judicial doctrine of substantial compliance found in subdivision (e) shall apply to all contracts entered into on or after January 1, 1992, and to all actions or arbitrations arising therefrom, except that the amendments to subdivisions (e) and (f) enacted during the 1994 portion of the 1993-94 Regular Session of the Legislature shall not apply to either of the following:

(1) Any legal action or arbitration commenced prior to January 1, 1995, regardless of the date on which the parties entered into the contract.

(2) Any legal action or arbitration commenced on or after January 1, 1995, if the legal action or arbitration was commenced prior to January 1, 1995, and was subsequently dismissed.”

The four separate, conjunctive conditions contained within subdivision (e) of the statute, the satisfaction of which would allow [REDACTED] Alarm Systems Inc. to invoke the “substantial compliance” doctrine, will, on their face, be difficult for it to meet. It (the corporation) had not been licensed as a contractor in California prior to the performance of its act or contract with its customer; it did not act reasonably or in good faith to maintain proper licensure; it either knew or reasonably should have known that it was not licensed when it performed its act or contract with its customer; and it did not act, at all, to reinstate its license on learning it was invalid. (Indeed, it had no license to reinstate in the first place.) So subsection (e), read literally and without further resort to case law, will not be of any help to our client.

The legislative history of Section 7031 as it pertains to the substantial compliance doctrine provides further bad news. On June 2, 1993, Assembly Member Bill Lancaster wrote to Senator Mello, explaining as follows:

"Dear Senator Mello: This letter is to communicate legislative intent on legislation I authored, Assembly Bill 1382, Chapter 632, Statutes of 1991.

While serving as the Assembly representative for Assembly District 62, I introduced AB 1382 allowing, under limited circumstances, contractors who are in 'substantial compliance' with the state licensing requirements to bring action in court for the collection of compensation for work requiring a contractor's license.

Specifically, AB 1382 (**Business and Profession Code, Section 7031(d)**) allows for the principal of substantial compliance to be applied in circumstances where the court determines that the licensee has been licensed within the 90 days preceding the performance of work for which compensation is sought, if it is found by the court that noncompliance was the result of (1) inadvertent clerical error, or (2) other error or delay not caused by the active negligence of the person.”

This letter was reprinted in the Senate Daily Journal for the 1993-94 Regular Session, at p. 1470. It seems to make clear that the legislative intent when Section 7031 was amended did not extend

beyond situations wherein the licensee had simply, through inadvertence, allowed its existing license to lapse. Such is not the case in our fact situation.

4. The Further Problem Presented by the Majority of California Case Law.

The effect of the statute on [REDACTED] Alarm Systems Inc. and Mr. [REDACTED] obviously threaten to be especially harsh. Our situation is not helped by the holding in *Construction Financial v. Perlite Plastering Co.*, 53 Cal.App.4th 170, 61 Cal.Rptr.2d 574 (2nd Dist.. 1997), in which the court flat out said that the Legislature has expressly rejected the doctrine of substantial compliance with state licensure requirements. There are literally dozens of reported cases in which language very similar to that appearing in *Construction Financial, supra*, is used.

When doctrines such as unjust enrichment, equitable estoppel, and the like are considered, the impact of the statutory scheme seems to be just plain *unfair*. But the courts have been quite uniform in holding that even when a defendant enjoys the full fruits of an unlicensed contractor's labors, and the contractor performs good work, and the defendant receives everything under the contract that he was expecting, the contractor *still* has no enforceable remedy. The public policy underlying this harsh result of deterring illegal contracting practices has been repeatedly said to outweigh the manifest unjust enrichment to which it can lead. See, e.g., *Jackson v. Pancake* (App. 3 Dist.. 1968) 266 Cal.App.2d 307, 72 Cal.Rptr. 111.

The effect of the rule has often been quite brutal when applied in real life. In *Weeks v. Merritt Bldg. & Const. Co.* (App. 1 Dist.. 1974) 39 Cal.App.3d 520, 114 Cal.Rptr. 209, for example, a licensed electrical subcontractor performed 73% of the work for which he had contracted on a large high rise apartment building. He then suffered a heart attack and was forced to turn the remaining 27% of the work over to a third party, which turned out to be unlicensed. The Court of Appeals confirmed that regardless of these circumstances, the original contractor was precluded from recovering *anything* despite his substantial performance rendered before he was struck ill.

The rule is not new or recent to California. Over fifty years ago, the Court of Appeals held without equivocation that to recover monies owed in return for its work, a contractor must both allege and prove that it was licensed *at all times* during the performance of the contract which it seeks to enforce. *Albaugh v. Moss Const. Co.* (App. 1 Dist.. 1954) 125 Cal.App.2d 126, 269 P.2d 936.

Attempts by unlicensed contractors to belatedly correct their inherent problem after first entering into a contract with a third party have met with mixed success. In *Owens v. Haslett* (App. 1950) 98 Cal.App.2d 829, 221 P.2d 252, for example, a general contractor entered into an agreement to construct a residential unit and commenced work on the project without first having procured the required license. He attempted to rectify this mistake by obtaining a license during the course of the work, i.e., while the contract was still being performed and before its conclusion. He was ultimately denied any recovery whatsoever, the court having held that the procurement of the license while the work was underway did not successfully validate the contract, and that therefore no action on the contract could be successfully maintained.

Since the holdings in older cases such as *Owens, supra*, the courts have appeared to relax the standard somewhat in recognition of the drastic outcome that was thereby being promulgated, to the extreme detriment of otherwise honest and capable contractors coupled with the unjust enrichment of the gleeful customers. *Vitek, Inc. v. Alvarado Ice Palace, Inc.* (App. 4 Dist.. 1973) 34 Cal.App.3d 586, 110 Cal.Rptr. 86, for instance, addressed a similar, though not identical, question to the one confronted in *Owens, supra*. But in *Vitek, Inc., supra*, a contrary result was attained: A contractor unlicensed at the time of contract formation that then obtained a license before it began and completed all work under the agreement was allowed to recover from its customer.

The *Vitek, Inc., supra* court's decision was a logical extension to other, also more recent holdings such as *Elster's Sales v. Longo* (App. 2 Dist.. 1970) 4 Cal.App.3d 216, 84 Cal.Rptr. 83. In *Elster's Sales, supra*, the Court of Appeals dealt with a scenario wherein an unlicensed contractor had commenced work on a project that was relatively inconsequential in relation to the totality of the work the customer wanted. The contract between the parties had not yet been executed when this work was performed; before it was executed, the contractor obtained a license, and then proceeded to perform the balance of the work. The court held that the contractor had "substantially complied" with the applicable licensing statute and could recover against the customer and the customer's guarantor even for the portion of the work performed before the license was obtained.

Vitek, Inc., supra represented a distinct departure from older holdings such as *Owens, supra*, and *Grant v. Weatherholt* (App. 1954) 123 Cal.App.2d 34, 266 P.2d 185, both of which had absolutely precluded recovery notwithstanding the obtaining of a license during mid-performance.

5. Specific Exceptions to the Rule Prohibiting Recovery Wherein a Contracting Entity Has "Substantially Complied" by Utilizing a License Held by One or More of Its Principals or Employees.

The gradual evolution easing the courts' interpretations of California's seemingly stringent statutory requirements concerning "substantial compliance" as a road toward potential recovery for unlicensed contractors began shortly before *Vitek, Inc., supra* and *Elster's Sales, supra*, when courts began to make statements along the lines of those found in *Latipac, Inc. v. Superior Court of Marin County* (1966) 64 Cal.2d 278, 411 P.2d 564, 49 Cal.Rptr. 676. In *Latipac, supra*, the California Supreme Court indicated that the courts should not insist on literal compliance with the contractor's licensing law in situations wherein the customer, seeking to escape his obligation to pay, has in fact received the full protection which the statute was intended to provide.

The *Latipac, Inc., supra* court also went on to note that the pattern and history of the contractor's licensing statute reflects a legislative determination that the fitness of a corporation to enjoy a license necessarily reposes in the competence and experience of one or more individuals who qualify on its behalf. Recognizing that a corporation cannot in and of itself be "qualified" to do anything, the court noted that a corporate contractor's method of qualifying for its contractor's license is dependent on its demonstration that one or more of its members – commonly known as

the “responsible managing officer” – possesses the knowledge and experience required in order to procure the license.

Latipac, Inc., supra went on to spawn several subsequent decisions each of which supported, in general, the proposition that so long as a licensed “responsible managing officer” was present to act on a corporation’s behalf, the fact that the corporation itself was unlicensed was not preclusive to recovery under the statutory bar that *Business & Professions Code* §7031 would otherwise present.⁴ It is true that not every court which has considered the question has ruled in this fashion; in at least one case, the Court of Appeals opined that a corporation that was unlicensed at the time the contract was entered into and during which the work was performed had not “substantially complied” with the licensing statute and could not maintain an action to foreclose its mechanic’s lien, even though its sole owner, president, chairman of the board, and responsible managing officer was personally licensed and physically managed the work performed under the contract. *General Ins. Co. of America v. Superior Court of San Bernardino County* (App. 4 Dist.. 1972) 26 Cal.App.3d 176, 102 Cal.Rptr. 541. But a review of all of the relevant case authority indicates that *General Ins. Co. of America, supra*, expresses a view which is now distinctly in the minority.

In *Weeks v. Merritt Bldg. & Const. Co.* (App. 1 Dist.. 1974) 39 Cal.App.3d 520, 114 Cal.Rptr. 209, the court held that an unlicensed contractor could successfully recover under the theory of “substantial compliance” if, despite some failure to literally comply with the statutory licensing requirements, the customer seeking to escape his obligation to pay has received the full protection which the statutory regulatory scheme contemplates (namely, protection against botched construction projects by unlicensed contractors who could probably not qualify for a license even if they had applied for one).

With this prelude of several years, along came, finally, the holding in *Knapp Development & Design v. Pal-Mal Properties, Ltd.* (App. 2 Dist.. 1985) 173 Cal.App.3d 423, 219 Cal.Rptr. 44. There, the court held that a corporation had “substantially complied” with the provisions of *Business & Professions Code* §7031 even though it did not hold a contractor’s license at the time the contract was entered into or at any time during the performance of the agreement. The holding was predicated on the underlying facts that the corporation’s president and principal shareholder was a licensed general contractor at all times, so that the responsibility and competence of the corporation’s managing officer were officially confirmed throughout the

⁴ Long before *Latipac, Inc., supra*, a holding that had seemingly been lost in the welter of decisions interpreting and applying the contractor licensing law came in the form of *Citizens State Bank of Long Beach v. Gentry* (App. 2 Dist.. 1937) 20 Cal.App.2d 415, 67 P.2d 364. This holding involved facts wherein a licensed contractor who was an individual commenced work under a contract; then formed his own closely-held corporation; then caused the corporation to procure its own separate contractor’s license at the time his individual license expired. Although the work had been commenced by the individual, it was finished by the corporation. The court held that the corporation and the individual should be considered to be one and the same entity under these circumstances, and that the individual was entitled to foreclose his lien when the customer declined to pay because he should be “deemed” to have had a license throughout the duration of the work.

period during which the contract was being performed. The facts in *Knapp Development & Design, supra*, are squarely “on all fours” with the facts presented by our current situation involving [REDACTED] Alarm Systems Inc. and its owner, Mr. [REDACTED].

Somewhat different facts, but very similar analysis, were involved in *Asdourian v. Araj* (1985) 38 Cal.3d 276, 696 P.2d 95, 211 Cal.Rptr. 703. There, the California Supreme Court held that a contractor had “substantially complied” sufficiently with the licensing statute to afford him a legal remedy even though he had obtained the requisite license in the name of a business he had intended to incorporate, but instead continued to operate as a sole proprietorship. Sometimes he did business under his own name, and sometimes in the name of the corporation. The court opined that the policy underlying the licensing statutes had been satisfied because the license provided evidence of the qualifications of the party who actually did the physical work, and indicated that the issuance of a second license would not have provided the customer with any greater assurances or knowledge than he had already been afforded.

This favorable line of reasoning culminated in the decision in *G.E. Hetrick & Associates, Inc. v. Summit Construction & Maintenance Co.* (App. 2 Dist. 1992) 11 Cal.App.4th 318, 13 Cal.Rptr.2d 803, *reh. den. and modified, rev. den.* The court held in this case that the contractor’s license held by the principal of a corporation that had entered into a contract to perform construction work would suffice to permit the corporation to recover for its services, despite the fact that the corporation itself lacked a valid license, under the theory of “substantial compliance.” The court further held that the licensed principal was not required to be personally present at all times at the construction site in order to qualify as the “responsible managing officer” of the corporate contractor.

Taking the holdings in *Knapp Development & Design, supra*, *Asdourian, supra*, and particularly *G.E. Hetrick & Associates, Inc., supra* into account, [REDACTED] Alarm Systems Inc. would probably have been able to successfully overcome any challenge its customer might seek to present based purely on the fact that the corporation itself was unlicensed, given that Mr. [REDACTED] himself at all relevant times held a valid license.

6. The Demise of the 1966-1992 Favorable Case Law.

The Court of Appeal cogently explained what happened in the wake of the holding in *G.E. Hetrick & Associates, Inc., supra*, in its decision in *Pacific Custom Pools, Inc. v. Turner Construction Company* (2000) 79 Cal.App.4th 1254, 94 Cal.Rptr.2d 756:

“Through a series of cases beginning in 1966, the courts attempted to alleviate the severity of the application of section 7031 by allowing recovery to a contractor who has *substantially complied* with the licensing statutory scheme. (*Asdourian v. Araj* (1985) 38 Cal.3d 276, 283, 211 Cal.Rptr. 703, 696 P.2d 95; *Latipac, Inc. v. Superior Court* (1966) 64 Cal.2d 278, 281, 49 Cal.Rptr. 676, 411 P.2d 564; *Gaines v. Eastern Pacific* (1982) 136 Cal.App.3d 679, 682-683, 186 Cal.Rptr. 421; *Airfloor Co. of California, Inc. v. Regents of University of California* (1978) 84 Cal.App.3d 1004,

1010, 149 Cal.Rptr. 130; *Vitek, Inc. v. Alvarado Ice Palace, Inc.* (1973) 34 Cal.App.3d 586, 590, 110 Cal.Rptr. 86; *Lewis v. Arboles Dev. Co.* (1970) 8 Cal.App.3d 812, 816-817, 87 Cal.Rptr. 539.)

In reaction to this development in the law, the Legislature amended section 7031 in 1989 to add a subsection (d) which provided that the substantial compliance doctrine shall not apply to that statute. (Stats.1989, ch. 368, § 1; *Hydrotech Systems, Ltd. v. Oasis Waterpark*, *supra*, 52 Cal.3d at p. 996, fn. 5, 277 Cal.Rptr. 517, 803 P.2d 370.) In 1991, the Legislature further amended section 7031 to provide an exception to the prohibition of the substantial compliance doctrine where noncompliance with licensure requirements was the result of inadvertent clerical error or other error or delay not caused by the negligence of the licensee. [Footnote omitted] (See *Construction Financial v. Perlite Plastering Co.* (1997) 53 Cal.App.4th 170, 177-178, 61 Cal.Rptr.2d 574.)”

The *Pacific Custom Pools, Inc.*, *supra* court went on to further explain:

“Section 7031, subdivision (d) was amended in 1994 to its present state. The statute reads:

‘(d) 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, 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, and (3) did not know or reasonably should not have known that he or she was not duly licensed....’

An unlicensed contractor may thus avoid the consequences of the prohibition against the substantial compliance doctrine under section 7031, subd. (d) if the contractor proves that it had been licensed before performing work, acted reasonably in trying to maintain a license and did not know or reasonably should not have

known that it was not licensed.”

79 Cal.App.4th 1254, at 1262.

The same court then explained the rationale that will doubtlessly be argued by Superior Security Alarm Systems Inc.’s adversary regarding the effects of the previously referenced 1966-1992 line of cases that would have been favorable to our clients:

“The cases cited by PCP to support its contentions regarding substantial compliance, *G.E. Hetrick & Associates, Inc. v. Summit Construction & Maintenance Co.* (1992) 11 Cal.App.4th 318, 13 Cal.Rptr.2d 803 and *Airfloor Co. of California, Inc. v. Regents of the University of California, supra*, 84 Cal.App.3d 1004, 149 Cal.Rptr. 130 are inapposite based upon their individual facts and the different language of section 7031 as it existed at the time those cases were decided.”

79 Cal.App.4th 1254, at 1263.

Pacific Custom Pools, Inc., supra, is for the moment the “last word” on the law in this area. (Recall that earlier, in 1997, the court in *Construction Financial, supra*, had said that the Legislature has expressly rejected the doctrine of substantial compliance with state licensure requirements.) The *Pacific Custom Pools, Inc., supra* holding has been cited in seven separate subsequent decisions to date, five of which have been ordered to be unpublished and noncitable pursuant to *California Rules of Court Rule 977(a)*. The two published, citable opinions, *MW Erectors, Inc. v. Niederhauser Ornamental and Metal Works Co., Inc.* (Cal.App. 4 Dist. 2004) 9 Cal.Rptr.3d 351, and *Slatkin v. White* (2002) 102 Cal.App.4th 963, 126 Cal.Rptr.2d 54, deal with other irrelevant issues raised in *Pacific Custom Pools, Inc., supra*, and have no bearing or effect on its reasoning for purposes of this Memorandum. Neither do any of the five unpublished, noncitable holdings.

It appears most likely that the reasoning of *Pacific Custom Pools, Inc., supra* will be dispositive of the factual scenario faced by [REDACTED] Alarm Systems Inc. and Mr. [REDACTED]. Quite simply, the decisions of the 1966-1992 period that amounted to very favorable law which would have allowed our clients to avail themselves of the “substantial compliance” doctrine have subsequently been “trumped” by the will of the Legislature, a conclusion amply supported by the *Pacific Custom Pools, Inc., supra* holding.

7. A Possible Way to Avoid Section 7031’s Statutory Preclusion of [REDACTED] Alarm Systems Inc.’s Claim Against Its Customer.

In the face of Section 7031’s amended provisions which [REDACTED] Alarm Systems Inc. will be forced to confront, another potential avenue may be available to salvage its claim against its customer. Specifically, should [REDACTED] Alarm Systems Inc. assign its contractual rights to recovery as against its customer to a bona fide third party, that third party, so long as it is capable of qualifying as a “holder in due course” of the assigned rights, would likely be able to

recover from the customer even though [REDACTED] Alarm Systems Inc. was presumably statutorily required to be licensed in its own name. Moreover, the rules for qualification as a holder in due course have in at least one case been held to be rather lax. In *Appel v. Morford* (App. 2 Dist., 1943) 62 Cal.App.2d 36, 144 P.2d 95, the court held that even though the plaintiff assignee was the majority stockholder, president, and general manager of the corporate construction contractor/assignor, when he presented uncontroverted testimony that he had no knowledge or information when he bought the corporation's contractual rights against its customer that the corporation's contractor's license had not been renewed, the evidence was sufficient to support a finding that he was a "holder in due course" of the contractual rights and was therefore entitled to maintain suit thereon irrespective of the assignor's failure to comply with the licensing statute.

The assignment to a holder in due course strategy has not gone unnoticed by commentators. The following observation is set forth at 44 A.L.R.4th 271, "Failure of Building and Construction Artisan or Contractor to Procure Business or Occupational License as Affecting Enforceability of Contract or Right of Recovery for Work Done – Modern Cases," §2[b]:

"Counsel for an unlicensed contractor or artisan should be aware of the possible advantage of assigning his client's interest in the proceeds from a particular project to a third person. *It appears that in the event of an assignment the assignee can recover on the contract even if he is not a licensed contractor himself.* In one case in which a contractor partially assigned the proceeds of a construction contract to a noncontractor for interim financing purposes, it was found that the assignee was not required to allege and prove that it was a registered contractor at the time of the assignment in order to recover under the contract."⁵ [Emphasis added]

Based on the current state of the law, an assignment of [REDACTED] Alarm Systems Inc.'s claim to a third party capable of qualifying as a holder in due course appears to be the only avenue through which the claim preclusion effect of *Business & Professions Code* Section 7031 may successfully be avoided.⁶

⁵ The case to which this Annotation refers is *Van Waters & Rogers, Inc. v. Interchange Resources, Inc.* (1971) 14 Ariz. App. 414, 484 P.2d 26.

⁶ While somewhat beyond the scope of this Memorandum, under the circumstances it is worthy of note that UCC §3-302(1) provides that a holder in due course is a holder who takes the instrument for value, in good faith, and without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person. Code §1-201(19) defines "good faith" as honesty in fact in the conduct or transaction concerned, and Code §1-201(25) provides that a person has "notice" of a fact when (a) he has actual knowledge of it; or (b) he has received a notice or notification of it; or (c) from all the facts and circumstances known to him at the time in question, he has reason to know that it exists. In general, the test for determining

CONCLUSION

This would not exactly be the first time a customer attempted to get something for nothing by raising a contractor's technical lack of a license as a defense against a collection action. But unfortunately for [REDACTED] Alarm Systems Inc. and Mr. [REDACTED], the circa-1966-1992 California case law interpreting Section 7031 in a manner that would enable recovery has now been superseded by a rather clear statement of intention of the Legislature to the effect that these cases are no longer "good law." The exceptions to the general rule elucidated by the holdings in *Knapp Development & Design, supra*, *Asdourian, supra*, and particularly *G.E. Hetrick & Associates, Inc., supra* all would have seemed to fit our factual pattern very squarely; however, for the reasons described above, their analysis appears to no longer be valid. Our plaintiff's upcoming complaint will likely be subject to attack by general demurrer, a motion for summary judgment, or ultimately the assertion of the non-license defense at trial by the defendant.

I will, as always, be happy to answer any additional follow-up questions you may have regarding this matter and to discuss the analysis presented in this Memorandum with you.

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good faith is not the objective one of prudence, due care, negligence, diligence, or failure to inquire, but a subjective one of knowledge of facts which render the taking dishonest. By definition, therefore, it is unlikely that [REDACTED] Alarm Systems Inc. could assign its claim to Mr. [REDACTED] in a manner that would leave him as a holder in due course, considering he has full knowledge of all of the facts surrounding the claim. And attempting to assign the claim to a third party without revealing all of the underlying facts would be problematic inasmuch as it would amount to fraud to the extent that the new holder paid anything for the claim.

APPENDIX “A” TO MEMORANDUM

Airfloor Co. of California, Inc. v. Regents of University of Cal. (1978, 4th Dist.) 84 Cal.App.3d 1004, 149 Cal.Rptr. 130

American Sheet Metal, Inc. v. Em-Kay Engineering Co. (1979, E.D. Cal.) 478 F.Supp. 809 (applying California law)

Asdourian v. Araj (1985) 38 Cal.3d 276, 211 Cal.Rptr. 703, 696 P.2d 95

Brown v. Solano County Business Development, Inc. (1979, 1st Dist.) 92 Cal.App.3d 192, 154 Cal.Rptr. 700

Brunzell Constr. Co. v. Barton Development Co. (1966, 1st Dist.) 240 Cal.App.2d 442, 49 Cal.Rptr. 667

Buzgheia v. Leasco Sierra Grove (1997) 60 Cal.App.4th 374, 70 Cal.Rptr.2d 427

Culbertson v. Cizek (1964, 1st Dist.) 225 Cal.App.2d 451, 37 Cal.Rptr. 548

Dahl-Beck Electric Co. v. Rogge (1969, 1st Dist.) 275 Cal.App.2d 893, 80 Cal.Rptr. 440

Davis Co. v. Superior Court of San Diego County (1969, 4th Dist.) 1 Cal.App.3d 156, 81 Cal.Rptr. 453

Domach v. Spencer (1980, 3d Dist.) 101 Cal.App.3d 308, 161 Cal.Rptr. 459

E. C. Ernst, Inc. v. County of Contra Costa (1982, N.D. Cal.) 555 F.Supp. 122 (applying California law)

Elster's Sales v. Longo (1970, 2d Dist.) 4 Cal.App.3d 216, 84 Cal.Rptr. 83

Fairlane Estates, Inc. v. Carrico Constr. Co. (1964, 4th Dist.) 228 Cal.App.2d 65, 39 Cal.Rptr. 35

Famous Builders, Inc. v. Bolin (1968, 5th Dist.) 264 Cal.App.2d 37, 70 Cal.Rptr. 17

Fillmore v. Irvine (1983, 3d Dist.) 146 Cal.App.3d 649, 194 Cal.Rptr. 319

Frank v. Kozlovsky (1970, 2d Dist.) 13 Cal.App.3d 120, 91 Cal.Rptr. 297

General Ins. Co. v. St. Paul Fire & Marine Ins. Co. (1974, 2d Dist.) 38 Cal.App.3d 760, 113 Cal.Rptr. 613

General Ins. Co. v. Superior Court of San Bernardino County (1972, 4th Dist.) 26 Cal.App.3d 176, 102 Cal.Rptr. 541

Holland v. Morse Diesel Intern., Inc. (2001) 104 Cal. Rptr.2d 239

Hydrotech Systems, Ltd. v. Oasis Waterpark (1991) 52 Cal.3d 988, 803 P.2d 370, 277 Cal.Rptr. 517, 91 CDOS 722, 91 Daily Journal DAR 1106

J. B. Gaines v. Eastern Pacific (1982, 2d Dist.) 136 Cal.App.3d 679, 186 Cal.Rptr. 421

Johnson v. Mattox (1968, 1st Dist.) 257 Cal.App.2d 714, 65 Cal.Rptr. 185

Latipac, Inc. v. Superior Court of Marin County (1966) 64 Cal.2d 278, 411 P.2d 564, 49 Cal.Rptr. 676

Lewis v. Arboles Development Co. (1970, 2d Dist.) 8 Cal.App.3d 812, 87 Cal.Rptr. 539

MW Erectors, Inc. v. Niederhauser Ornamental and Metal Works Co., Inc. (2004) 115 Cal.App.4th 512, 9 Cal.Rptr.3d 351

Muth v. Leineke (1970, 3d Dist.) 9 Cal.App.3d 433, 88 Cal.Rptr. 1

Pacific Custom Pools, Inc. v. Turner Construction Co. (2000) 79 Cal.App.4th 1254, 94 Cal.Rptr.2d 756

Pickens v. American Mortg. Exchange (1969, 1st Dist.) 269 Cal.App.2d 299, 74 Cal.Rptr. 788

Power City Communications, Inc. v. Calaveras Tel. Co. (1968, E.D. Cal.) 280 F.Supp. 808 (applying California law)

Proffitt & Durnell Plumbing, Inc. v. David H. Baer Co. (1966, 2d Dist.) 247 Cal.App.2d 518, 55 Cal.Rptr. 764

Ranchwood Communities Limited Partnership v. Jim Beat Construction Co. (1996) 49 Cal.App.4th 1397, 57 Cal.Rptr.2d 386

Roy Bros. Drilling Co. v. Jones (1981, 2d Dist.) 123 Cal.App.3d 175, 176 Cal.Rptr. 449

Rushing v. Powell (1976, 5th Dist.) 61 Cal.App.3d 597, 130 Cal.Rptr. 110

Smith v. Workers' Compensation Appeals Bd. (2002) 96 Cal.App.4th 117, 116 Cal.Rptr.2d 728

Vaughn v. De Kreek (1969, 3d Dist.) 2 Cal.App.3d 671, 83 Cal.Rptr. 144

Weeks v. Merritt Bldg. & Constr. Co. (1974, 1st Dist.) 39 Cal.App.3d 520, 114 Cal.Rptr. 209