Substantial Compliance with the Contractors' State License Law: An Equitable Doctrine Producing Inequitable Results

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I. Introduction

A licensed and bonded contractor was awarded a bid for contractor services that resulted in the execution of a contract with a property owner. During performance of the contract, the contractor’s license became due for renewal. The contractor timely submitted an application for renewal with the appropriate fee. The State Contractors License Board received the application for renewal and acknowledged timely receipt of the application. The contractor therefore assumed that its renewal application was being processed. Due to backlog, however, the board did not process the contractor’s license until more than nine months later. Worse yet, the renewal application was then returned to the contractor for lack of a required signature. Within twenty-four hours of learning of the rejection of its application, the contractor flew to the board’s Sacramento office where a new renewal application form was signed and a new check tendered. After curing the licensure lapse, the contractor continued to satisfactorily perform all obligations under the contract. The contract was near completion when a dispute arose between the contractor and property owner regarding payment. The parties were unable to resolve their dispute and four years of litigation ensued.

On the eve of trial, the property owner requested an evidentiary hearing to determine whether the contractor was duly licensed or, alternatively, had substantially complied with the licensure law during the performance of their contract. Following this hearing, the contractor’s claim was dismissed on the ground that the contractor was negligent in failing to renew its license and in permitting the license to expire. This ruling was made despite the contractor’s timely
application for licensure renewal and good faith effort to cure the defect after notification.¹

Under existing law, a contractor who brings a civil action to recover compensation for the performance of contractor services must allege that he or she was a licensed contractor at all times during the performance of the contract.² Simply alleging proper licensure, however, only allows a contractor who has suffered a licensure lapse to maintain a cause of action so long as this allegation is not controverted by the opposing party. If licensure is controverted, an evidentiary hearing must be held to determine whether the contractor was, in fact, licensed or had “substantially complied” with licensure requirements under section 7031(d) of the California Business and Professions Code.³ Section 7031(d) provides that the court may determine substantial compliance with the licensing statute if the 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.”⁴

Although section 7031(d) appears to clearly define the circumstances that must exist in order for a contractor to invoke the substantial compliance exception, the confusing evolution of this doctrine has led many practitioners to question the proper scope of its application. Prior to the amendment of section 7031 in 1989, the courts created what has been commonly referred to as the “doctrine of judicial substantial compliance.”⁵ The doctrine of judicial substantial compliance permitted “the judiciary to overlook the technical

². See CAL. BUS. & PROF. CODE § 7031 (West 1995).
³. See KENNETH C. GIBBS & GORDON HUNT, CALIFORNIA CONSTRUCTION LAW 26 (16th ed. 2000). This evidentiary hearing is held pursuant to section 402 of the California Evidence Code which provides for an evidentiary hearing to determine certain preliminary facts. See CAL. EVID. CODE § 402 (West 1995).
⁴. CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
failure of a contractor to comply with section 7031 where the deviation from the requirements of the statute is of little significance."  

To reign in the liberality with which courts were invoking and applying judicial substantial compliance, the legislature amended section 7031 in 1989 and added section (d), which states that "[t]he judicial doctrine of substantial compliance shall not apply to this section."  

In 1991, the legislature amended the contractors' licensing law for a second time to resurrect substantial compliance, but only if it was shown  

at an evidentiary hearing that the person was a duly licensed contractor during any portion of the 90 days immediately preceding the performance of the act or contract; and the person's category of licensure would have authorized the performance of that act or contract; and that noncompliance with the licensure requirement was a result of (1) inadvertent clerical error, or (2) other error or delay not caused by the negligence of the person.  

This measure was encouraged by the increasingly widespread belief that denying a contractor access "to the courts to collect legitimate debts on completed work for the sole reason that he was unlicensed at some point during the contractual period is a harsh and potentially inequitable result."  

Thus, this amendment was "intended to ensure that a contractor's ability to operate as a licensed contractor is not jeopardized because of a technical error or oversight by the contractor" in maintaining his or her license.  

Although this

6. Renee A. Mangini, The Contractors' State License Law: from Strict Adherence to Substantial Compliance, 9 WHITTIER L. REV. 613, 620 (1987); see Rodney Moss, Substantial Compliance with Contractor's Licensing Law, L.A. LAW., July/Aug. 1986, at 49 (explaining that the concept of judicial substantial compliance "involves overlooking the technical failure to comply with section 7031 where the deviation from the requirements of the statute are minor or of little consequence").  

7. CAL. BUS. & PROF. CODE § 7031(d) (West, WESTLAW through 1990 statutes annotated-historical).  

8. CAL. BUS. & PROF. CODE § 7031(d) (West, WESTLAW through 1992 statutes annotated-historical).  

9. Mangini, supra note 6, at 616.  

amendment resurrected the idea of substantial compliance, by 1994 the legislature believed that the scope of this measure was too limited to carry out the purposes for which it was enacted and the exception was amended for a third time in 1995.

The current doctrine of substantial compliance was enacted in 1995 to alleviate the severe consequences imposed on a contractor who failed to strictly comply with the licensing statute. The current substantial compliance exception requires a contractor to prove that he or she "(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." Despite the legislature's effort to expand the doctrine of substantial compliance, the current substantial compliance exception to section 7031 does not advance the public policies supporting section 7031 and, arguably, does not expand the scope of the 1991 amendment because both forms of the exception turn on whether the contractor was negligent in maintaining his or her license.

The trial court's ruling in West Coast attests to the harsh penalty suffered by contractors who have not rigidly adhered to the licensing law and have inadvertently allowed their license to lapse. The consequence of failing to strictly adhere to the licensing law is "particularly severe where the failure is essentially technical." West Coast also illustrates the potential inequitable and harsh result imposed against contractors under both the 1991 and 1995 amendments to the substantial compliance doctrine and, consequently, exposes the legislature's failed attempt to expand the scope of the current substantial

12. CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
13. The court noted that the 1989 amendment to section 7031(d) of the California Business and Professions Code controlled in this case because that version of the statute was in effect at the time the contract was entered into between the contractor and owner. Reporters Transcript of Proceedings, April 19, 2000, pages 54-56.
14. Moss, supra note 6, at 49. The result in West Coast is particularly severe because although the renewal application was technically defective for lack of signature, the contractor had no control over the backlog causing the California State License Board to process the renewal application more than nine months after submission.
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compliance exception beyond that of its predecessor.15 As a result, property owners are still permitted to not only breach an agreement with a contractor licensed at the time of contract formation with impunity, but also to become unjustly enriched at the hands of the law. This Comment will expand upon these, and other, shortcomings of the current substantial compliance doctrine.

First, the legislature's purpose in enacting a contractors' licensing law and the public policies which support the law are discussed. Next, the statutory and common law evolution of the substantial compliance doctrine is reviewed. Lastly, this Comment illustrates the deficiencies of the statutory substantial compliance doctrine and explains the reasons why a return to the doctrine of judicial substantial compliance is preferable to the current legislative formulation.

II. THE PUBLIC POLICIES SUPPORTING THE LICENSING LAW AND THE COMMON LAW RATIONALE FOR PRECLUDING UNLICENSED CONTRACTORS FROM RECOVERING ON CONTRACT

The California legislature enacted the Contractors' State License Law in 193916 for the purpose of protecting "the health, safety, and general welfare of the public."17 Specifically, the licensing law protects "the public from incompetence and dishonesty in those who provide building and construction services" and provides "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."18 The licensing law accomplishes its purpose by requiring applicants to show general knowledge of the administrative principles of the contracting business. Applicants must be "knowledgeable of any California building, safety, health and lien laws which may be

15. The court ruled that even if the 1991 or 1995 amendments to the Business and Professions Code were to control in this case, the contractor did not substantially comply with the meaning of either of these two versions of the section. Reporters Transcript of Proceedings, April 19, 2000, pages 54-56.
17. Mangini, supra note 6, at 615.
'necessary for the safety and protection of the public’” before the state will issue a license.19

The licensing statute was designed to provide an incentive for contractors to procure a license in that section 7031 precludes unlicensed contractors from using the courts to enforce contracts which contractors have entered into in an unlicensed status.20 “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.”21

At the time the legislature enacted section 7031, however, the novelty of this sanction and the incentive created to procure a license was illusory in light of the illegal nature of such contracts22 and the well-established principle that a court of law will not enforce an illegal contract or the rights arising out of an illegal transaction.23 The enactment of section 7031 rendered a judicial determination on the legality of a contract for which a license was required unnecessary. “Rather than finding that a contract is illegal due to lack of a license, and applying the rule that illegal contracts are void and unenforceable, the court may simply look to the statute which provides ‘no license, no pay.’”24

Although the courts refused to aid in the enforcement of an illegal contract, they have been fully aware of the injustice which may

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19. Mangini, supra note 6, at 616 (quoting CAL. BUS. & PROF. CODE § 7068(a) (West 1995)).
22. See CAL. BUS. & PROF. CODE § 7028(a) (West 1995) (“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, unless such person is particularly exempted from the provisions of this chapter.”).
23. See Wise v. Radis, 74 Cal. App. 765, 775, 242 P. 90, 94 (1925) (“No principle of law is better settled than that a party to an illegal contract or an illegal transaction cannot come into a court of law and ask it to carry out the illegal contract or to enforce rights arising out of the illegal transaction.”).
24. Mangini, supra note 6, at 618.
result between the parties. It is well established that the contractors' licensing law "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."25 Despite the greater public interest in promoting health, safety, and the deterrence of illegal conduct, the courts could not escape the inequities resulting from strict enforcement of the licensing statute. "The courts have enforced this statute with some reluctance, since strict enforcement may cause an unconscionable forfeiture that is not well fitted to the gravity of the offense."26

Another reason for abandoning strict adherence is the inconsistent reasoning supporting the statute. For example, it does not necessarily follow that an unlicensed contractor does not have the requisite skill and knowledge to perform competently without jeopardizing the health and safety of the public. Accordingly, it did not take the judiciary long to realize that qualified and skilled contractors were being denied compensation for legitimate debts under the statute simply because they were unlicensed. The California Supreme Court recognized that strict enforcement of the licensing law was not necessary to satisfy the legislative intent of section 7031 and the trend in construing section 7031 slowly changed from one of strict adherence to substantial compliance.

III. TO BE OR NOT TO BE: THE CONFUSING EVOLUTION AND CONFLICTED DEVELOPMENT OF THE SUBSTANTIAL COMPLIANCE DOCTRINE UNDER SECTION 7031

A. The Transition from Strict Adherence to Substantial Compliance

In 1946, only seven years after the enactment of section 7031, the California Supreme Court recognized the potential inequity that resulted from an unnecessarily strict construction of section 7031.27

25. JAMES ACRET, CALIFORNIA CONSTRUCTION LAW MANUAL § 4.05, at 224 (5th ed. 1997).
26. Id. at 223.
It was not until 1966, however, that the California Supreme Court in *Latipac, Inc. v. Superior Court*\(^\text{28}\) set the parameters for judicial substantial compliance by setting forth three requisite elements for the application of the doctrine. The *Latipac* court held that the contractor must hold a valid license at the time of contracting, a renewal of the license must be readily secured, and the responsibility and competence of the contractor's managing officer must be officially confirmed throughout performance of the contract if the doctrine of substantial compliance is to be applied.\(^\text{29}\)

With regard to the first element, the court held that a contractor holding a valid license at the time of contract formation executes a contract valid at its inception and that the possession of a valid license substantiates the contractor's ability to perform the various occupational undertakings.\(^\text{30}\) The *Latipac* court held that "[t]he key moment of time when the existence of the license becomes determinative is the time when the other party to the agreement must decide whether the contractor possesses the requisite responsibility and competence and whether he should, in the first instance, enter into the relationship." It is during this period of contract formation that "[t]he license, as an official confirmation of the contractor's responsibility and experience, then plays its important role."\(^\text{32}\) Thus, the court held that a contractor who successfully, although belatedly, secures renewal of a license that it held at the inception of the contract will be accorded proper deference in ascertaining whether the policy of the statute has been satisfied.\(^\text{33}\)

The second element, an immediate renewal of the license, further attests to the contractor's continued competence throughout performance of the contract and its good faith in seeking reinstatement. In *Latipac*, the contractor explained that it assigned the responsibility for renewing the license to its office manager, and that the manager suffered an emotional breakdown and was subsequently committed to a mental institution which made timely detection of the licensure

\(^{28}\) 64 Cal. 2d 278, 411 P.2d 564, 49 Cal. Rptr. 676 (1966).

\(^{29}\) See id. at 281-82, 411 P.2d at 567-68, 49 Cal. Rptr. at 679-80.

\(^{30}\) See id. at 282, 411 P.2d at 568, 49 Cal. Rptr. at 679.

\(^{31}\) Id.

\(^{32}\) Id.

\(^{33}\) See *Latipac*, 64 Cal. 2d at 283, 411 P.2d at 569, 49 Cal. Rptr. at 681.
lapse difficult. As a result, the contractor performed services under the contract after the license had expired for approximately ten months. The license was not renewed until two months after contract completion.

Despite this untimely renewal, the Latipac court held that it may afford significance to the renewal in determining whether the policy of the statute had been satisfied so long as there was no "indication that plaintiff's fitness to enjoy a license fluctuated between the expiration and renewal of its license." The court was not presented with any evidence suggesting that plaintiff's competence or responsibility were impaired during the period following the licensure lapse, so, accordingly, this element of the three-prong test was satisfied.

Lastly, the verification of the competence and responsibility of the contractor's managing officer was considered fundamental to a "legislative determination that the fitness of a corporation to enjoy a contractor's license lies in the competence and experience of the individual who qualifies on its behalf." The office manager in Latipac functioned as a qualifier for a number of other corporations. The court looked to the valid contractors' licenses held by these other corporations during the period of contract performance in the present case as evidence of the office manager's experience and

34. See id. at 281, 411 P.2d at 567, 49 Cal. Rptr. at 679.
35. See id. at 280, 411 P.2d at 567, 49 Cal. Rptr. at 679.
36. See id.
37. Id. at 284, 411 P.2d at 569, 49 Cal. Rptr. at 681.
38. Id. at 285, 411 P.2d at 570, 49 Cal. Rptr. at 682.
39. If a corporation applies for a contractor's license, the corporation must qualify through either a responsible managing officer (RMO) or responsible managing employee (RME) who is qualified in the licensing classification for which the corporation is applying. See CAL. BUS. & PROF. CODE § 7068(b)(3) (West 1995). The RMO or RME must be a bona fide officer or employee of the corporation and must be actively engaged in the work covered by the license. See CAL. BUS. & PROF. CODE § 7068(d) (West 1995). Under regulations promulgated by the Contractor's State License Board, a "bona fide" employee is 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(a) (1984). The qualifier must also exercise direct supervision over the work for which the license is issued to the extent necessary to secure full compliance with the provisions of the license law. See CAL. BUS. & PROF. CODE § 7068.1 (West 1995).
case as evidence of the office manager’s experience and competence in its consideration of the contractor’s license renewal application. Since all three requisite elements were present in \textit{Latipac}, the court refrained from determining “whether any of them, singly or in more limited combination, would constitute ‘substantial compliance.”’\textsuperscript{40}

Following the \textit{Latipac} decision, the trend to liberally expand the application of substantial compliance continued so long as the purpose of the licensing law had been satisfied. The invocation of substantial compliance became “appropriate where despite some failure of literal compliance with the licensing requirements ‘the party seeking to escape his obligation has received the full protection which the statute contemplates.”’\textsuperscript{41} This policy was further evidenced in the 1979 case of \textit{Brown v. Solano County Business Development, Inc.}\textsuperscript{42} There the court held that the objective of protecting the public from dishonest, incompetent, and financially irresponsible contractors was not fulfilled merely because the contractor possessed a license at the time of contracting and for a brief period during performance.\textsuperscript{43}

An increasingly liberal interpretation of the substantial compliance doctrine continued into the 1980s when the California Supreme Court in \textit{Asdourian v. Ara\textsuperscript{j}}\textsuperscript{44} held that a failure to satisfy all three of the requisite elements introduced in \textit{Latipac} would not contravene a contractor’s claim so long as the contractor had substantially complied with the state licensing law in a way which satisfied the legislative policy.\textsuperscript{45} In the same year, \textit{Knapp Development & Design v. Pal-Mal Properties, Ltd.}\textsuperscript{46} held that the applicability of the substantial compliance doctrine hinged upon whether the contractor could

\textsuperscript{40} \textit{Latipac}, 64 Cal. 2d at 281, 411 P.2d at 567, 49 Cal. Rptr. at 679. \textit{But see} Lewis v. Arboles Dev. Co., 8 Cal. App. 3d 812, 87 Cal. Rptr. 539 (1970) (holding that all three elements of \textit{Latipac} need not be present in order to constitute substantial compliance where the contractor made no showing that the contractor readily secured renewal of its expired license).


\textsuperscript{42} 92 Cal. App. 3d 192, 154 Cal. Rptr. 700 (1979).

\textsuperscript{43}\textit{See id.}

\textsuperscript{44} 38 Cal. 3d 276, 696 P.2d 95, 211 Cal. Rptr. 703 (1985).

\textsuperscript{45} \textit{See id.} at 284, 696 P.2d at 100, 211 Cal. Rptr. at 708.

\textsuperscript{46} 173 Cal. App. 3d 423, 219 Cal. Rptr. 44 (1985).
establish that the contractor’s managing officer was competent and responsible throughout the performance of the contract.\textsuperscript{47}

Consequently, despite the strong public policies underlying enforcement of section 7031 and the illegal nature of contracts executed by unlicensed contractors, the foregoing authorities illustrate the degree of liberality exercised by the courts in applying section 7031. The courts applied section 7031 flexibly to achieve equitable results while also being careful not to compromise the ultimate purpose of the statute in protecting the public from incompetent and irresponsible contractors. In 1989, however, the application of substantial compliance was put to an end when section 7031 was amended and the judicial doctrine was eliminated.

\textbf{B. The Legislature Eliminates the Doctrine of Judicial Substantial Compliance}

After the 1989 amendment to section 7031, adding subsection (d), which provided that “[t]he judicial doctrine of substantial compliance shall not apply under this section,”\textsuperscript{48} it soon became apparent that contractors must strictly adhere to the licensing statute and make certain that they are properly licensed throughout the course of performance if they have any hope of using the court system to recover amounts they contend are due to them.

In \textit{Hydrotech Systems, Ltd. v. Oasis Waterpark},\textsuperscript{49} the first case interpreting section 7031 after the 1989 amendment, the California Supreme Court held that section 7031 bars not only contract actions

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\item \textsuperscript{47} See id. at 434, 219 Cal. Rptr. at 50. The Contractors’ State License Law was technically violated, but the policy of the law was not violated since the responsible managing officer’s license sufficiently ensured responsible and competent performance.
\item \textsuperscript{48} CAL. BUS. \& PROF. CODE § 7031(d) (West, WESTLAW through 1990 statutes annotated-historical).
\item \textsuperscript{49} 52 Cal. 3d 988, 803 P.2d 370, 277 Cal. Rptr. 517 (1991).
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by unlicensed contractors, but tort actions for fraud as well. In its ruling, the court stated:

Regardless of the equities, section 7031 bars all actions, however they are characterized, which effectively seek compensation for illegal unlicensed contract work . . . . It follows that an unlicensed contractor may not circumvent the clear provisions and purposes of section 7031 simply by alleging that when the illegal contract was made, the other party had no intention of performing. Section 7031 places the risk of such bad faith squarely on the unlicensed contractor’s shoulders. 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 into an illegal arrangement in the first place.

C. The Legislature Reinvents a Narrow Substantial Compliance Exception to Section 7031

In 1991, the legislature amended section 7031(d) to provide for a very narrow substantial compliance exception if it was shown at an evidentiary hearing that the person was a duly licensed contractor during any portion of the 90 days immediately preceding the performance of the act or contract . . . [and] that the person’s category of licensure would have authorized the performance of that act or contract, and that non-compliance with the licensure requirement was a result of (1) inadvertent clerical error, or (2) other error or delay not caused by the negligence of the person.

In Construction Financial LLC v. Perlite Plastering Co., section 7031(d) was interpreted for the first time after the 1991

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50. See id. at 999, 803 P.2d at 376-77, 277 Cal. Rptr. at 523-24 (stating that the “deterrent and protective purposes of section 7031 preclude recovery even when the person who solicited the unlicensed work did act in bad faith”) (emphasis added).

51. Id. at 997-98, 803 P.2d at 376, 277 Cal. Rptr. at 523 (emphasis added).

52. CAL. BUS. & PROF. CODE § 7031(d) (West, WESTLAW through 1992 statutes annotated-historical).

amendment. In that case, Diversified Gypsum Corporation was formed to do subcontract work for Perlite Plastering Company, Inc. One of the principals of Diversified held a specialty license in drywall and, on the advice of Perlite, Diversified did not apply for specialty licenses or designate their license-holding principal as the responsible managing operator. Instead, Diversified applied for and obtained a general contractor's license through a long-time employee of Perlite, who went to work for Diversified as a foreman and its RME. Thus, Diversified held a general contractor's license. The RME worked for Diversified for several months until he was either fired—as the RME understood matters—or it was suggested that he take a long-term leave of absence to deal with certain health and family matters—as Diversified's principal understood matters. Shortly after the RME's departure, Diversified commenced work under a subcontract with Perlite to install drywall. The project was scheduled for completion on November 25, 1992, but was not completed until September 9, 1993. As a result of the delay, Diversified brought suit against Perlite and the general contractor's payment bond claiming damages in excess of $800,000.

The case proceeded to a bifurcated trial on the issue of whether Diversified held a valid contractor's license at the time it performed the work sued upon; or if not, whether Diversified substantially complied with the licensing requirement. The trial court found that because Diversified's RME was no longer employed by Diversified when it commenced work on the project, Diversified did not have a valid contractor's license of any kind when it performed the work. In spite of the fact that the principal's specialty licenses would have authorized the work had those licenses been held by Diversified, the

54. In Construction Financial, the trial court decided that the 1991 amendment controlled because this action was commenced on December 20, 1993. See id. at 178 n.3, 61 Cal. Rptr. at 578 n.3. Section 7031(e)(1) provides that the "amendments to subdivisions (d) and (e) enacted during 1994 portion of the 1993-1994 Regular Session of the Legislature shall not apply to . . . [a]ny legal action or arbitration commenced prior to January 1, 1995, regardless of the date on which the parties entered into the contract." CAL. BUS. & PROF. CODE § 7031(e)(1) (West 1995).


56. See id. at 174, 61 Cal. Rptr. 2d at 575-76.
trial court held that Diversified did not have a license authorizing its work on the project. The court based its holding on the fact that section 7031 precluded Diversified from recovering against the bonding company unless it could prove substantial compliance.\(^{57}\)

Diversified argued that it should not have been denied recovery because the legislative purpose of the licensing law was carried out at all times during performance to the extent that Diversified’s principal was at all times a licensed drywall contractor. While suggesting in dicta that this argument would be successful if the case was still governed by the judicial doctrine of substantial compliance, the court affirmed the trial court’s ruling that Diversified’s negligence caused its noncompliance with the licensing law.\(^{58}\) Diversified should have known that the departure of their RME also meant the departure of their license.\(^{59}\)

In response to Diversified’s argument that they relied on Perlite’s representation that they need not procure any specialty licenses, the court revisited the holding in *Hydrotech*\(^{60}\) which states that section 7031 applies even when the person for whom the work was done knew that the contractor was unlicensed.\(^{61}\) The court stated that “[t]he Supreme Court has also held that a contractor may not plead reliance upon another person in determining what is required under the Law; unlicensed contractors are held to knowledge of the Law’s requirements.”\(^{62}\)

After the court’s decision in *Construction Financial*, substantial compliance with the licensing law was to be recognized in situations “where a person lacks licensure *due to an error beyond his or her control*”\(^{63}\) and situations “in which nonlicensure would not be attributable to a contractor’s negligence.”\(^{64}\) Notwithstanding this lip

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\(^{57}\) See *id.* at 175, 61 Cal. Rptr. 2d at 575.

\(^{58}\) See *id.* at 184, 61 Cal. Rptr. 2d at 582.

\(^{59}\) See *id.*


\(^{61}\) See *id.* at 997, 803 P.2d at 376, 277 Cal. Rptr. at 523.


\(^{63}\) *Id.* at 183, 61 Cal. Rptr. 2d at 581.

\(^{64}\) *Id.* at 184, 61 Cal. Rptr. 2d at 582 (emphasis in original). The court presented the factual scenario in which a contractor mails a timely renewal application and fee and begins work on a new project assuming that there would
service to the doctrine of substantial compliance, the courts made it patently clear that the importance of deterring unlicensed persons from engaging in the construction contracting business outweighs any harshness of the result, regardless of whether the unlicensed contractor suffered a breach of contract or was even the victim of fraud. Even fraud in the inducement did not get the contractor in *Hydrotech* around the bar of section 7031. It is therefore clear that the lack of a license operates as a complete defense to any claim by an unlicensed contractor to recover compensation whether based on contract, unjust enrichment, or even fraud.

D. The Legislature Attempts to Expand the Doctrine of Substantial Compliance to Alleviate the Overly Harsh Consequences of Strict Adherence

In 1994, the legislature reinvented the doctrine of substantial compliance to “remove the overly harsh application of the Contractors’ State License Law which in court actions denies contractors payment for services rendered when for clerical or otherwise minor errors they become unlicensed during the term of a contract.” Accordingly, the legislature amended section 7031 and set forth three new requirements for establishing statutory substantial compliance. It now must be shown at an evidentiary hearing that the person acting 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.66

be no problem with his or her application and that the application would be processed. However, if the renewal application were lost in the mail, or for any number of reasons beyond the contractor’s control was not processed before the expiration of the contractor’s license, the contractor may be unlicensed while performing the work. The contractor has not been negligent in this situation. See id.


66. CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
The application of these three elements is illustrated in *Pacific Custom Pools, Inc. v. Turner Construction Co.*

In *Pacific Custom Pools*, a subcontractor’s claim for compensation was dismissed, although the contractor was licensed before commencing work on the project, because its license became suspended pursuant to California Business and Professions Code section 7071.6. The contracting company’s president submitted affidavits in opposition to defendants’ motion for summary judgment stating that he was unaware of the license suspension. The contracting company’s president was unaware of the licensure suspension because the president was unaware of the judgment entered against the contracting company which triggered the suspension. The materials supplier obtained a judgment against the contracting company because, unbeknownst to the contracting company, its bonding company had filed for bankruptcy. During the period in which the contractor’s license was suspended, the contractor received a license renewal application from the California State Licensing Board advising the contractor fourteen months in advance of the license expiration date and stating that “[a] license cannot be renewed active while under suspension.” Approximately one month after the contractor’s license expired, the board contacted the contractor to inform it that the contractor’s renewal application was untimely and that its license was still suspended. Twenty days later, the board notified the contractor that the suspension had been lifted but that the license had expired. Approximately one month later, the board notified the contractor that its renewal application was not processed and that the

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68. *See id.* at 1257-59, 94 Cal. Rptr. 2d at 758-59. Section 7071.6 “required a licensee to notify the registrar of contractors of the California State License Board in writing of any entered and unsatisfied judgments within 90 days from the date of judgment. Failure to provide such notification results in automatic license suspension.” *Id.* at 1262-63, 94 Cal. Rptr. 2d at 762; *see* CAL. BUS. & PROF. CODE § 7071.6 (West 1995).
70. *Id.*
71. *See id.*
72. *See id.*
license remained in an expired condition because they had presented a dishonored check with the renewal application.\textsuperscript{73}

The contracting company’s president submitted an affidavit stating that he discovered the licensure suspension the very same month in which the license was due to expire.\textsuperscript{74} After discovering the licensure suspension, he attempted to contact the claimant and, upon learning of the claimant’s demise, contacted the claimant’s successor and reached an agreement for satisfaction of the remaining debt.\textsuperscript{75} When proof of the satisfaction was submitted to the California State License Board, suspension of the contractor’s license was lifted.\textsuperscript{76} Based upon these facts the appellate court affirmed summary judgment for the defendants because the contractor “could not establish that it ‘acted reasonably and in good faith to maintain licensure’ or that it ‘did not know or reasonably should not have known’ that it was not ‘licensed.’”\textsuperscript{77}

Consequently, the legislature has only seemingly eliminated “restriction [of the substantial compliance doctrine] to ‘inadvertent clerical error,’ as well as the issue of the contractor’s negligence, in favor of a standard based on the contractor’s reasonableness and good faith.”\textsuperscript{78} Additionally, the legislature expanded application of the exception to include situations in which “the contractor’s prior licensure may have been at an undefined prior time rather than the more restrictive ‘90 days immediately preceding’ the subject contract.”\textsuperscript{79}

\textsuperscript{73} See id.
\textsuperscript{74} See id. at 1262, 94 Cal. Rptr. 2d at 761.
\textsuperscript{75} See id. at 1263, 94 Cal. Rptr. 2d at 762.
\textsuperscript{76} See id.
\textsuperscript{77} Id. at 1265, 94 Cal. Rptr. 2d at 764.
\textsuperscript{78} GIBBS & HUNT, supra note 3, at 27.
\textsuperscript{79} Id.
IV. A MODEST PROPOSAL TO ELIMINATE STATUTORY SUBSTANTIAL COMPLIANCE TO RECAPTUR THE ESSENCE OF EQUITY AND FAIRNESS WHICH CHARACTERIZED JUDICIAL SUBSTANTIAL COMPLIANCE

The courts have construed and applied the Contractors' License Law mindful of two conflicting policies:

On one hand, the license law should be strictly enforced in order to protect consumers from abuse by unqualified contractors. On the other, strict enforcement may prevent an innocent, though technically unlicensed, contractor from recovering compensation for satisfactory work to the unjust enrichment of a conniving owner.  

The judiciary and legislature have sought to find the appropriate balance between these two competing interests within the parameters of the substantial compliance doctrine.

The problem with the doctrine, in its current form, is that there has been a failure to reach an appropriate balance between these interests. The current substantial compliance doctrine was introduced to alleviate the overly harsh application of the Contractors' State License Law, yet the doctrine is unnecessarily restrictive in advancing the interests that section 7031 was designed to protect.  

For instance, even if a contractor "acted reasonably and in good faith to maintain proper licensure and . . . did not know or reasonably should not have known that he or she was not duly licensed," it does not necessarily follow that the public policies and legislative intent which prompted the enactment of section 7031 were advanced. Likewise, it is logically fallacious to believe that a failure to act

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81. For example, in West Coast Transfer Service Inc. v. Tutor-Saliba-Perini, J.V., LASC No. BC 143376 (2000), expiration of the contractor's license near completion of the contract did not pose a threat to public safety or threaten the possibility that the owner had received incompetent services. Moreover, the contractor was bonded at all times during performance of the contract which provided the owner with a source of recovery for defective and shoddy work which may have resulted from a contractor's unlicensed status. Under the current formulation of substantial compliance, these considerations are not accounted for although they bear upon the very reasons for the existence of section 7031.
82. CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
reasonably and in good faith to maintain proper licensure means that the public policies and legislative intent underlying section 7031 are not met. It is not necessarily true that an unlicensed contractor does not possess the requisite knowledge to perform contractor services competently, or that a licensed contractor is rendered incompetent upon a negligent lapse of his or her license.

A legislative formulation of substantial compliance may not be able to provide for consideration of all facts relevant in determining whether the public interests of section 7031 have been violated and whether the conduct of the contractor in renewing a lapsed license can reasonably be called "substantial compliance." The judiciary, on the other hand, provides an appropriate forum for consideration of all relevant factors weighing in on the issue of substantial compliance. Accordingly, statutory substantial compliance should be eliminated in favor of judicial substantial compliance. This measure would ensure that the public policies underlying section 7031 are satisfied and overly harsh applications of section 7031 are avoided.

The current legislative formulation defining substantial compliance is inadequate because the elements comprising substantial compliance do not guarantee that the public policies of section 7031 will be satisfied. Specifically, the public policies underlying section 7031 are not advanced when a contractor who negligently allowed his or her license to expire is precluded from bringing (1) a suit for recovery or (2) a suit for fraudulent inducement against a property owner for whom services were rendered. To achieve better alignment between the substantial compliance exception and the public policies which support the contractors' licensing law, the legislature should relinquish its hand in dictating to the courts when application of the substantial compliance doctrine is appropriate rather than continually tinkering with the statutory language of the exception.

A. The 1995 Amendment to Section 7031 Has Not Alleviated the Unjust Consequences of Strict Adherence Under the 1991 Amendment

The substantial compliance provision of section 7031 was amended in 1995 to avoid the unjust results of the substantial compliance doctrine under the 1991 amendment. The legislature's intent has not been realized, however, because under both versions of the
statute substantial compliance can only be established if a contractor is able to prove that he or she was not negligent in maintaining his or her license.\textsuperscript{83} Accordingly, under the 1991 version of section 7031, a contractor could only establish substantial compliance with the licensure law if he or she could prove that the "noncompliance with the licensure requirement was a result of inadvertent clerical error or other error or delay not caused by the person's negligence."\textsuperscript{84}

In \textit{Construction Financial},\textsuperscript{85} decided under the 1991 amendment, the trial court's finding that the subcontractor's failure to have a valid license due to its negligence was, by itself, enough to support the dismissal.\textsuperscript{86} The plaintiff contractor argued that "when the Legislature amended section 7031(d) in 1991, it could not have intended to disqualify from application of the substantial compliance doctrine every contractor who was unlicensed owing to negligence as ordinarily defined in tort law."\textsuperscript{87} "[T]he consequences of acting as a contractor without being licensed are so severe that any person of ordinary prudence would use \textit{extraordinary} care to assure that he or she was licensed before undertaking work requiring a contractor's license."\textsuperscript{88} This is likely because "even extremely minor lapses of diligence in maintaining licensure would be 'negligent' under ordinary negligence standards."\textsuperscript{89} Ultimately, the court refused to find application of substantial compliance in circumstances involving even "excusable neglect" and found that ordinary negligence would

\textsuperscript{83} In \textit{West Coast}, the court found that the contractor had not substantially complied with either the 1991 or 1995 amendments due to its negligence in failing to renew its license and permitting the license to expire. Reporters Transcript of Proceedings, April 19, 2000, pages 54-56.

\textsuperscript{84} \textit{CAL. BUS. & PROF. CODE § 7031(d)} (West, WESTLAW through 1992 statutes annotated-historical).

\textsuperscript{85} 53 Cal. App. 4th 170, 61 Cal. Rptr. 2d 574 (1997).

\textsuperscript{86} For a fuller discussion of the facts in \textit{Construction Financial}, see \textit{supra} section III. C.

\textsuperscript{87} \textit{Constr. Fin., LLC v. Perlite Plastering Co.}, 53 Cal. App. 4th 170, 181, 61 Cal. Rptr. 2d 574, 580 (1997). Tort law defines "negligence" as "the failure to use ordinary or reasonable care" or "that care which persons of ordinary prudence would use in order to avoid injury to themselves or others under circumstances similar to those shown by the evidence." \textit{Id.} at 181-82, 61 Cal. Rptr. 2d at 580.

\textsuperscript{88} \textit{Id.} at 182, 61 Cal. Rptr. 2d at 581 (emphasis in original).

\textsuperscript{89} \textit{Id.}
preclude invocation and application of the substantial compliance doctrine.

Similarly, substantial compliance could only be satisfied under the 1995 version if the contractor established that he or she "acted reasonably and in good faith to maintain proper licensure, and did not know or reasonably should not have known that he or she was not duly licensed."90 In Pacific Custom Pools, dismissal was affirmed because the contractor could not establish that it acted reasonably and in good faith to maintain licensure or that it did not know or reasonably should not have known that it was not licensed.91

Although it appears as if the legislature "eliminated the restriction to 'inadvertent clerical error,' as well as the issue of the contractor's negligence,"92 this conclusion is questionable in light of the new standard based upon the contractor's reasonableness and good faith in maintaining its license. The cornerstone of both the 1991 and 1995 standards is the contractor's "reasonableness," which, in tort law, is the factual determination required to find negligence. Furthermore, whether the 1995 amendment really removes "inadvertent clerical error" from the substantial compliance equation is also disputable because the legislature clearly intended to "remove the overly harsh application of the Contractors' State License Law which . . . denies contractors payment for services rendered, when for clerical or otherwise minor errors, they become unlicensed during the term of the contract."93

Consequently, although the legislature intended to expand the scope of substantial compliance under the 1995 amendment, the application of substantial compliance under the 1995 amendment is not distinguished from that under the 1991 amendment. Case law construing and applying substantial compliance under both versions of section 7031(d) supports this observation.94

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90. CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
92. GIBBS & HUNT, supra note 3, at 27.
94. In dictum, the trial court in West Coast went out of its way to find that the contractor did not substantially comply with the contractors' license law
B. The Public Policies Supporting Section 7031 Are Not Advanced When a Contractor Who Has Negligently Maintained His or Her License Is Denied Compensation

Section 7031 precludes a contractor from recovering compensation when the contractor did not act reasonably or in good faith to maintain proper licensure or knew, or reasonably should have known, that he or she was not licensed. However, the nexus between promoting safety and competence in the construction industry and precluding contractors who negligently allowed their licenses to lapse is tenuous. It does not follow that a greater degree of competence, quality of workmanship, and overall safety will be achieved by barring those who negligently allow their contractors' licenses to lapse from enforcing their contractual right to payment. Arguably, the threat of payment preclusion provides contractors with an incentive to obtain and maintain their license in good standing. Assuming this is true, a contractor's license still does not guarantee competence or quality workmanship. Likewise, the negligent lapse of a contractor's license does not necessarily mean that services rendered are incompetent or substandard. For example, no safety concerns are presented to either the contractor's clients or society in general when a contractor has negligently allowed his license to lapse because the contractor has already demonstrated the knowledge and skill required to become licensed.

Moreover, if the purpose of section 7031 is to protect the public from fraudulent contractors, then the statute should really only

under either the 1991 or 1995 amendment due to the contractor's own "active" negligence. See Reporters Transcript of Proceedings, April 19, 2000, pages 54-56. A comparison of the courts' application of substantial compliance in Construction Financial and Pacific Custom Pools reveals the marginal distinction, if any, between the 1991 and 1995 versions of substantial compliance. Compare Constr. Fin., 53 Cal. App. 4th at 182, 61 Cal. Rptr. 2d at 581 (noting that the legislature only intended to create "an extremely narrow exception to the licensure requirement, which would apply only where a contractor was without a license owing to circumstances truly beyond his control"), with Pac. Custom Pools, 79 Cal. App. 4th at 1265, 94 Cal. Rptr. 2d at 764 (holding that plaintiff was precluded from recovery because it could not establish that "it acted reasonably and in good faith to maintain licensure" or that it "did not know or reasonably should not have known that it was not "licensed").

95. See CAL. BUS. & PROF. CODE § 7031(d) (West 1995).
96. See Sickels, supra note 16, at 298 (stating that the purpose of the Contractors' License Law was to afford the public effective and practical protec-
preclude contractors who intentionally, knowingly, or with a high degree of recklessness, allow their licenses to expire. The punishment imposed by section 7031 in barring compensation to contractors who have merely suffered a negligent lapse of their license sweeps too broadly, sanctioning those who were merely negligent in maintaining their licenses. This is an unjust and unfortunate result considering that the legislature intended to preclude compensation to those who acted, or failed to act, with a more culpable mental state to prevent and discourage fraud in the construction industry.

The expiration of a license due to negligence does not, in and of itself, render a contractor incompetent, or his or her work unsafe, and the sanction imposed by section 7031 exacts a heavy price for negligence in the process of deterring those who fraudulently hold themselves out as licensed contractors. Consequently, precluding a contractor who has inadvertently, and perhaps negligently, allowed his or her license to expire from recovering compensation for services does not advance the legislative intent underlying section 7031.

C. The Public Policies of Section 7031 Are Not Advanced When a Contractor Who Negligently Maintained His or Her License Is Not Permitted to Maintain an Action for Fraud

"An unlicensed contractor cannot recover compensation for construction work by alleging and proving fraud in the inducement of the construction contract."97 The foregoing public policies are not advanced when a contractor is not permitted to maintain an action for fraud in the inducement although he or she was merely negligent in allowing his or her license to lapse.

Prior to 1989, "[a] favorite avenue for recovery [for unlicensed contractors] has been to allege promissory fraud, or fraud in the inducement of the contract. By alleging that the owner, at the time when the contract was formed, did not intend to fulfill its promise to pay for work to be performed by the contractor, contractors sought to overcome the nonlicensure defense."98

97. ACRET, supra note 25, at 227.
In *Pickens v. American Mortgage Exchange*, the court held that even an unlicensed contractor could file suit for fraudulent inducement. The plaintiff alleged that the defendant represented to the plaintiff that the property on which the contractor was to perform services was “encumbered only to the extent of $30,000, when, in fact, there was an additional encumbrance, a second deed of trust in the sum of $25,000, and in reliance on these representations” plaintiffs performed services and furnished materials to the worksite. As a result of plaintiff’s reliance on the defendant’s misrepresentations in deciding to execute their contract, the court held that even though the plaintiffs

could not recover on the contract, nor for the breach of it, nor for the value of the work or for monies expended therein, the fact that [the plaintiffs] were unlicensed did not bar them from the prosecution of their cause of action for fraud by which they were induced to enter the contract.1

After 1989, however, this avenue of recovery was eliminated. In *Hydrotech Systems, Ltd. v. Oasis Waterpark*, the court rejected Hydrotech’s argument that it was induced to enter into the contract by a promise the defendant did not intend to keep, that it would not have entered into the contract but for the false promise to pay, and, consequently, that the plaintiff was not seeking compensation for unlicensed work, but instead was seeking damages for fraud. The court held that an “unlicensed contractor may not circumvent the clear provisions and purposes of section 7031 simply by alleging that when the illegal contract was made, the other party had no intention of performing.”102

Although promissory fraud was frequently asserted to get around the licensure defense and unlicensed contractors were recovering unpaid sums in spite of the licensure law’s purpose to protect property owners from incompetence and fraud by unlicensed contractors, it is unlikely that the legislature intended to extend these protections to property owners who fraudulently induce unlicensed contractors to perform services. The Contractors State License

100. Id. at 303, 74 Cal. Rptr. at 792.
102. Id. at 998, 803 P.2d at 376, 277 Cal. Rptr. at 523.
Board’s manual entitled *What You Should Know Before You Hire a Contractor* clearly states that the licensure law is “designed to protect the consumer.” This manual also informs the consumer about the risks inherent in doing business with an unlicensed contractor. Accordingly, a property owner who fraudulently induces an unlicensed contractor into an agreement, not only intends to contract with the unlicensed contractor, and assumes any and all risks of incompetent or shoddy workmanship, but also arguably fails to fall within the category of persons the licensure law was designed to protect.

Not only does preclusion of a contractor’s claim for fraud encourage property owners to engage in fraud by allowing them to benefit from their own fraud, but it also enables one party with unclean hands to become unjustly enriched at the hands of the law. Consequently, property owners who fraudulently induce unlicensed contractors to perform contractor services should not be able to seek protection under the licensure law after they have perpetrated a fraud on the contractor and, upon entering a contract with an unlicensed contractor, have willfully refused the protections offered under section 7031.

V. CONCLUSION

The doctrine of judicial substantial compliance was conceived over fifty years ago to avoid the harsh penalty of noncompensation imposed under strict adherence to the contractors’ licensing law. The legislature’s elimination of this equitable doctrine in 1989 and the subsequent enactment of several measures to reinvent the exception have imposed an unjustifiable and unreasonable burden upon contractors who inadvertently allow their licenses to expire. The
penalty of noncompensation for violating the contractors’ licensing law is not only inappropriate considering the gravity of the offense, but it also fails to advance the public policies supporting the contractors’ licensing law. Although the legislature has acted to curtail the harsh and restrictive application of the contractors’ licensing law in recent years by continually amending the statutory language of the substantial compliance exception, this method of remedying the severe consequences caused by an overly restrictive application of the substantial compliance doctrine inadequately addresses the fundamental unfairness imposed on contractors. Accordingly, the judiciary should, once again, be entrusted with the fair and just application of the contractors’ licensing law and the substantial compliance exception so that the public policies underlying the licensing law, as well as those which prompted the birth of a substantial compliance exception, are satisfied.

The concern that a return to judicial substantial compliance will result in uncertainty and inconsistency to the extent that judicial “substantial compliance’ can have different meanings to different persons and there is great difficulty in anticipating when substantial compliance might be found” is overstated in light of the efficient, effective, and equitable application of the substantial compliance doctrine under the three-pronged test established by Latipac. This three-pronged test established a certain legal standard to determine whether judicial substantial compliance had been satisfied and it was this standard which was the “focal point in resolving questions of claims by unlicensed contractors from 1966 to 1985.” Unlike the current statutory scheme, the Latipac court introduced a test for applying the substantial compliance doctrine which was better aligned with the policies supporting the contractors’ license law. For example, the guidelines introduced in Latipac did not bar a class of persons from compensation—i.e., those who negligently maintained

106. Moss, supra note 6, at 49.
107. Latipac, Inc. v. Superior Court, 64 Cal. 2d 278, 281-82, 411 P.2d 564, 567, 49 Cal. Rptr. 676, 679 (1966) (establishing that the contractor must hold a valid license at the time of contracting, a renewal of the license must be readily secured, and the responsibility and competence of the contractor’s managing officer must be officially confirmed throughout performance of the contract).
108. Moss, supra note 6, at 51.
their licenses—which was not contemplated by the legislature in the enactment of section 7031.

Additionally, the concern that reinstatement of judicial substantial compliance will result in the liberalization of the doctrine to the point that the public policies underlying the contractors' licensing law will no longer be achieved is also exaggerated. Just as the application of the judicial substantial compliance doctrine under Latipac and its progeny was limited to circumstances in which the court found no violation of the public policies supporting the contractors' licensing law, this limitation can be reestablished and followed once again.

Alternatively, it is the current form of the statutory substantial compliance exception which does not advance the public policies underlying the contractors' licensing law. The contractors' licensing law was designed to punish fraudulent contractors; not contractors who inadvertently make errors on their license renewal applications or otherwise negligently fail to renew their licenses.\(^{109}\) It is unlikely that a negligent lapse of a contractor's license would undermine the public policy of promoting competence and deterring fraud, just as a negligent licensure lapse does not, in and of itself, render a contractor incompetent or untrustworthy. The current statutory scheme does not advance the legislative intent of the contractors' licensing law and works a fundamental injustice against contractors who have negligently allowed their licenses to lapse. Accordingly, a return to judicial substantial compliance is preferable to the current statutory substantial compliance exception to section 7031.

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\footnotesize{\textsuperscript{109} See CAL. BUS. \& PROF. CODE § 7031(d) (West, WESTLAW through 1992 statutes annotated-historical) (requiring the contractor to establish that noncompliance with the licensure requirement was the result of inadvertent clerical error).}

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