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John E. Bulman

The Uniform Commercial Code and Construction Law: The Possible Applicability of Article 2

Scott K. Pomeroy

By John E. Bulman and Scott K. Pomeroy

While most construction law practitioners are familiar with the various common-law doctrines that arise in the field of construction contracting, practitioners must also keep article 2 of the Uniform Commercial Code (UCC) in mind when evaluating a new case, lest they be caught by surprise and find that their client's rights are governed by different rules than they expected. Because many contracts in the industry entail the performance of at least some services and are not purely for goods, a practitioner might overlook the possible application of article 2 only to discover, after it is too late, that his or her clients' rights or defenses are controlled by the UCC.

Predominant Purpose Test

The first issue, and one that is often overlooked, is to determine whether the UCC applies to a contractual dispute at all. Consider the following hypothetical: Your flooring contractor client was hired to install an acoustic-suppression flooring system in an industrial facility. Although your client installed the system correctly, it quickly became clear that the system lacks the strength and durability to withstand the manufacturing activities at the facility. Confident that you understand the issue, you advise that so long as the flooring system meets the owner's specifications,

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Roger C. Haerr

Understanding California's License Laws and Penalties for Contractors

By Roger C. Haerr

Everyone knows a contractor must be licensed. The penalties imposed against an unlicensed contractor vary among states. In California, substantial criminal and civil penalties may be imposed even for a technical lapse or suspension in the validity of a license during construction. The remedial purpose of the law is designed to protect the public, regardless of the equities involved.

This article examines California law to provide a basis for understanding the strict penalties in that jurisdiction and for comparison with other states. The question of

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Message from the Chairs

Drew Williams

Charlotte Wiessner

With the new bar year upon us and transitions taking place within the committee, we want to thank Patrick Greene for his leadership and hard work as committee cochair for the past three years. We are sorry to see him go, but the good news is that he has volunteered to be the editor for the committee's website and is busy whipping it into shape.

Our new cochair is Drew Williams. Drew was a cochair of the Programs Subcommittee for several years and shepherded various programs the committee put on at the Section Annual Meetings and for the Forum on the Construction Industry. We are very pleased he agreed to step up to the cochair position, and we look forward to working with him.

We are excited about this issue of *Construct!* It covers diverse topics, such as mechanic's liens, the Uniform Commercial Code, contractor licensing, and guaranteed maximum price contracts. If you have article ideas for upcoming issues of *Construct!*, please contact Dave Kurtz directly at dkurtz@bakerdonelson.com. If you would like your web-based articles linked to the committee's website, please submit them to Patrick Greene at pgreene@pecklaw.com. We particularly appreciate articles from our young lawyers, as well as articles that are geared to provide information to lawyers just starting out in the practice of construction law.

We look forward to another great year. The Section Annual Conference will be held in Miami in April 2011, and we encourage everyone to attend. Once again, the forum has asked the committee to put on a plenary program at its annual meeting in Scottsdale, Arizona, in April 2011. The program will focus on trying construction cases to juries and the use of jury consultants. We have a great panel and look forward to working again with the forum to bring quality CLE programs to its membership.

We are an equal opportunity committee and welcome participation by all of our members. Please get involved. We guarantee you will find it very rewarding.

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Rick Burnham

When Is a Guaranteed Maximum Price Not a Guaranteed Maximum Price?

By Rick Burnham

An owner who signs a contractor up to a guaranteed maximum price (GMP) contract should never have to pay more than the price that was guaranteed to be the maximum price, right? Wrong. Overruns in allowance items, exclusions, and assumptions contained in the contractor's proposal, scope changes, and circumstances such as waiting to resolve value engineering proposals until after the GMP is agreed to and the contract is signed are among the things that can result in increases to the GMP. When these risks are understood by both parties going into a project, chances of smooth sailing are enhanced. When they are not understood by one or both parties, the likelihood of a shipwreck is increased. This article touches on a few of the risks associated with the GMP.

Allowances

Allowances are used for a wide variety of matters. Frequently, they are used when the parties are in agreement that the plans and specifications are so devoid of description of some part of the work that there is simply inadequate information to develop reasonable pricing for that part of the work. Often they are used when selections of materials that can vary widely in price have not been made by the owner. Examples of this are carpeting, tile, and other finishes. An allowance prescribes a "plug number" for that work, typically with the understanding that as the design evolves or as the owner makes the choices necessary to define that work, the GMP will be adjusted up or down to the same extent that the actual cost of the allowance item exceeds or is less than the "plug number." This seems fairly simple.

Administratively, however, this simple, straight-forward pricing technique can become problematic. The following are two common issues:

1. What is the scope of the allowance? Was the "plug number" intended to cover the cost of the materials only? Or was it intended to cover materials, fabrication, delivery, and installation? What about freight charges, taxes, insurance, or mark-ups? In fact, the answer to these questions may vary from one allowance item to another, so carefully drafting contract provisions that address the specifics of each individual allowance provided for in the contract is the best way to eliminate (or at least minimize) this problem—especially if the parties actually read the contract and administer monthly progress billings in accordance with its terms.

2. When the actual cost of an allowance item exceeds the allowance, should the GMP automatically be increased? Or should that overrun first be charged to the contingency, with a change in the GMP coming only if the entire contingency is used up during the course of the project? In the absence of specific contract language stating otherwise, it is asserted that the answer to the first question is yes and the answer to the second question is no. Allowances and contingencies are two separate and distinct components of the GMP, and they need to be administered separately. To borrow a phrase from former Secretary of Defense Rumsfeld, allowances are for the "known unknowns," and the contingency is for the "unknown unknowns."

Exclusions and Assumptions

Simply stated, when a list of exclusions and assumptions is tied to a price, that price is "qualified," and it cannot rightly be said that a qualified price is "guaranteed maximum price." Whether the contractor chooses to label its list of qualifiers as exclusions and assumptions (the terms used in Standard Form AIA A102-2007), or qualifications, clarifications, or anything else, the effect is the same: The GMP may not really be a GMP.

Sometimes such lists are a necessary and helpful part of the full and open communication that ought to occur between owner and contractor prior to setting the GMP. However, if the exclusions and assumptions are extensive, it may be a sign that either it is too early in the design development process to set a GMP, or the contractor is subtly trying to minimize or avoid risks that are properly part of a contractor's undertaking in a GMP contract.

Regardless of a contractor's motivation for listing its exclusions and assumptions, the need for those qualifiers is driven by the extent to which the plans and specifications are not complete and by the potential cost associated with those details that are not shown on the GMP drawings. In other words, if at the time the GMP is agreed to, the drawings and specifications lack the detail needed for the parties to truly have a "meeting of the minds" about what is to be built for the GMP that is offered,

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accompanying the GMP with some qualifying or clarifying description is both understandable and helpful. Given that the essence of contracts is "this for that," when a contractor is asked to guarantee "this" (the price), it only seems reasonable for a contractor to want to clearly express its understanding of what "that" (the work) is.

Problems arise, however, when the contractual impact of such exclusions and assumptions is left unclear. For example, if the design as completed by the owner and its architect after the GMP is set is not consistent with the contractor's qualifiers and will result in a higher cost to the contractor, the contractor will surely point to its exclusion or assumption and ask the owner to increase the GMP accordingly. If the owner and architect, on the other hand, respond to such a request by pointing either to the contract provision in which the contractor acknowledges that the plans and specifications are incomplete and nevertheless assures the owner that the GMP is for a complete and fully functional project, or the contingency, the scene is set for disputes to arise. The best solution is to be as specific as possible in describing the effect that exclusions and assumptions could have on the GMP.

What is the baseline against which changes are measured?

Scope Changes

If, after signing a GMP contract, an owner decides to add square footage to the building that is the subject of that contract, it is natural to conclude to that the GMP must be changed to reflect that addition. That's an easy one.

But changes under a GMP contract are often problematic because the parties fail to recognize that changes need to be analyzed, and should be handled, differently than under the more common forms of design-bid-build lump-sum contracts. One reason for this is that most GMP contracts contain a clause that specifically states that the plans and specifications are incomplete and that the owner is relying on the contractor's expertise and experience to include in its price all that is necessary to provide a project that is complete and fully functional. Accordingly, the contractor in the GMP contract implicitly or explicitly accepts at least part of the risk associated with the incompleteness or insufficiency of the plans and specification. In practice, this provision is what enables the parties to enter into the contract and begin work in the field before the design is 100 percent complete; this is perhaps the most common reason for choosing the GMP format of contract in the first place. Nevertheless, this fundamental difference can make the identification of changes more difficult, and, although many GMP contracts have ample language describing how changes will be administered, many fail to provide a definition of a "change" that addresses this fundamental difference. This fundamental difference also frequently causes problems with subcontractors, who will insist that their price is based solely on what is clearly shown on the drawings or spelled out in the specifications. Hence, it is quite common for a GMP contractor to find itself in a situation where its subcontractor is entitled to a price increase under its subcontract, but the contractor is not entitled to one under its GMP contract.

Standard Form AIA A102 notes that the contractor has assumed the responsibility for including in its GMP further design development that is "consistent with the Contract Documents and reasonably inferable therefrom"; it also recites that the contemplated design development does not include "changes in scope, systems, kinds and qualities of materials." While this is helpful, and certainly true in the abstract, the likelihood of debates over what is "consistent" and "reasonably inferable" seems apparent.

The essential challenge that the parties are faced with when it comes to determining whether a change should affect the GMP is, What is the baseline against which changes are measured? Many experienced contractors and owners are used to pulling out the plans and specifications, and using them as the baseline; that is, if what is being asked of the contractor now is different from what is shown in the plans or described in the specifications, that difference defines the change. However, when the "baseline" is not only what is shown and described but also includes differences that are "consistent" with the contract documents and other differences that are "reasonably inferable" from those documents, the baseline is fuzzier, and the legitimate need for exclusions and assumptions is more apparent.

Standard Form AIA A102

5.2.5 To the extent that the Drawings and Specifications are anticipated to require further development by the Architect, the Contractor has provided in the Guaranteed Maximum Price for such further development consistent with the Contract Documents and reasonably inferable therefrom. Such further development does not include such things as changes in scope, systems, kinds and qualities of materials, all of which, if required, shall be incorporated by Change Order.

Unresolved Value Engineering Proposals

Quite often owners ask for, or contractors unilaterally offer, value engineering proposals that are intended to reduce the GMP without adversely affecting the quality of the project. These proposals are, of course, subject to change by the owner and incorporation of the change by owner's architect or

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engineer into the "For Construction" plans and specifications.

Value engineering proposals often come during the last moments of the negotiations leading up to the signing of the GMP contract, when time constraints prevent the full coordination of those proposals with the portions of the project affected by them. Though understandable perhaps, this lack of resolution unfortunately can lead to problems later on, when the design implementation and coordination takes place and it is discovered that either some part of the value engineering proposal is unacceptable to the architect or engineer or its implementation leads to cost increases in other aspects of the work that were not contemplated when the value engineering proposal was first made. Once again, the careful drafting of contract provisions to address these circumstances can help avoid later disputes. But to be most effective, the contractor and architect will both need to provide honest and open guidance to the drafters of the guidelines for resolving these technical issues.

Conclusion

Unmet expectations are frequently the most powerful force behind disputes. An understanding and working knowledge of the factors that can lead to increases in the guaranteed maximum price is essential to properly setting the parties' expectations. It is the hope of the author that this article enhances that understanding and facilitates the free and open communication that is essential to the success of all construction projects.

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Edward B. Gentilcore

Lien-ing Toward Payment

By Edward B. Gentilcore

With a growing number of projects facing financial difficulty, the importance of maintaining leverage for securing payment is greater than ever. The project itself remains a prime security target for any contractor, subcontractor, or supplier wishing to ensure that appropriate attention is given to their claims and that payment will be made in a timely and unencumbered manner. Some very recent developments in the realm of liens emphasize the ongoing attention that is being given to these statutes and the opportunity they provide for maximizing considerations of security and leverage.

First, Utah's lien law was amended to accommodate the prospect of bankruptcy. As is addressed below, there is an ever-increasing intersection between bankruptcy laws and lien laws insofar as they both address situations of financial distress. In fact, it is not at all unusual to have to be mindful of the bankruptcy implications of a lien filing as well as the given lien law's potential impact on how a claim will be pursued in the bankruptcy realm. Utah appears to have recognized the potential for conflict when the owner/developer files for bankruptcy and a contractor or subcontractor seeks to pursue their respective lien rights to secure payment.

Most often, the filing of a bankruptcy petition initiates the automatic stay provisions of the U.S. Bankruptcy Code. The potential lien claimant is then placed in a situation in which, to advance its lien, it has to be cautious that the filing of an action is not viewed to be in violation of the stay. While navigation of the automatic stay provisions is dependent in part on the individual states' lien laws viewed in conjunction with the Bankruptcy Code, Utah seems to have felt that an overarching protection of the contractor or subcontractor is preferred. Under the newly enacted amendment to the Utah lien law, the time for presentment of the lien enforcement action has been specifically modified to account for a bankruptcy filing. If the owner of the subject property becomes the subject of a bankruptcy proceeding before the expiration of the 180-day period to initiate an action for enforcement of the lien, the statutory amendment operates to extend that filing deadline. Under the amendment, the action may now be filed within 90 days after the automatic stay imposed by the applicable bankruptcy law ends by expiration or is otherwise lifted in the bankruptcy proceedings. *See* Utah Code § 38-1-11.

Second, in North Carolina, another lien development occurred, albeit in the courts. In a recent decision in *Wachovia Bank v. Superior Construction Corp.*, No. 07 CVS 21256 (N.C. Super. Ct., Apr. 23, 2010), the court aptly concluded that a waiver submitted in connection with a progress payment waived rights to make lien claims for the dollar amounts involved. However, what was unique about the decision is that the court also held that the waiver affected the "first date of furnishing," which is significant under North Carolina's lien statute to establish lien priority. On that score, the court concluded that with the language of the partial lien waiver included with the payment application, the "first date of furnishing" was reset to the effective date of the partial waiver.

The potential impact of this decision should not be overlooked. Contractors and subcontractors have somewhat routinely provided partial waivers of lien on projects because

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the waiver is being provided specifically to secure payment. While there are some rather unfortunate decisions suggesting that contractors or subcontractors who provide such waivers without actually obtaining payment might be operating at their own risk, those cases tend to remain in the minority. However, here the effectiveness of the waiver is not only as to the payments received but also potentially to *future* payments, because if the lien loses its priority as a security interest, its ability to gain the appropriate attention on the project will be significantly impaired. Even though this case may be the subject of further appellate review, the decision is certainly an important one for any party evaluating the potential impact of partial waivers of liens.

Oregon recently passed amendments to its Construction Lien Law of a dual nature, one from the perspective of the property owner and the other from the perspective of the potential subcontractor claimant. In the first instance, the Oregon amendments prohibit a purchaser of residential property from waiving its protection from potential claims of lien. In a similar vein, Oregon also has now prohibited an unlicensed subcontractor or those supplying materials, equipment, or labor to an unlicensed contractor from pursuing a lien against an "owner-occupied residence" property.

Pennsylvania recently took a much different step, expanding the potential for up-front waivers of liens on residential building projects. Pennsylvania now permits again under its Lien Law (much the same as it did upon its original passage in 1963) broad, up-front waivers of liens against residences and residential development projects as long as the property in question is a "residential building not more than three stories in height, not including any basement level, regardless of whether any portion of that basement is a grade level. . . ." This amendment certainly places a number of contractors and subcontractors in a much less advantageous position for securing payment on residential projects.

An earlier effort to modify substantially Pennsylvania's Lien Law in 2006 (effective in most instances in 2007) produced a wave of new cases. The first decision grappling with the 2006 amendments to the Lien Law came from Lancaster County in the case of *Brubacher Excavating, Inc. v. Commerce Bank/Harrisburg, N.A.*, 7 Pa. D. & C. 5th 173 (Lancaster County 2008). At issue was a lien filed against Commerce Bank's property by Brubacher, an asphalt paving sub-subcontractor. While Commerce Bank had arranged for having an up-front stipulation against liens filed appropriately in the Prothonotary's Office on October 3, 2006, stipulating against liens for materials and labor "necessary for cast stone work at the leased premises," Brubacher entered into its sub-subcontract to perform asphalt paving work on April 27, 2007.

The decision is important for any party evaluating the potential impact of partial waivers of liens.

As the court observed, Brubacher's sub-subcontract was executed almost four months after the effective date of the 2006 amendments. For that reason, after a discussion of the Pennsylvania Statutory Construction Act, 1 Pa. Cons. Stat. § 1501 et seq., the court ultimately concluded that the stipulation against liens, executed prior to the effective date of the 2006 amendments, would have no application to sub-subcontractor, Brubacher, whose contract was executed after the effective date of the 2006 amendments. While the court acknowledged that Commerce Bank's stipulation against liens "clearly remains effective for those contracts entered into before the effective date of the [2006 amendments]," "Brubacher had every right to expect that the amendments to the [Lien Law] applied to its contract, and that there would be no ability by the owner to avoid a lien should [Brubacher not be paid]." Further, the court observed:

> Commerce Bank could not waive a right that did not exist. A condition to the waiver of a right is that the right actually exists. There was no right for a sub-subcontractor to file a lien at the time the stipulation against liens was filed on October 3, 2006. As such, the stipulation against liens could not waive a right that did not even come into existence as a matter of statutory law until three months after the stipulation against liens was filed.

The court independently concluded that the stipulation against liens would not have extended to Brubacher in any event. The court held that the language of the lien waiver was limited to work identified within the body of the waiver. For that reason, applying strict construction principles to the waiver in question, the court concluded that Brubacher's asphalt supply work did not have any relation to "cast stone works," which were the subject of the stipulation against liens.

The matter was then brought before and addressed by the Superior Court of Pennsylvania. *Brubacher Excavating, Inc. v. Commerce Bank/Harrisburg, N.A.*, 995 A.2d 362 (Pa. Super. 2010). The court concluded that because the sub-subcontract was entered after the effective date of the 2006 amendments, the prohibition against prospective lien waivers applied. This conclusion did not give rise to a problem in this case,

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In re Fontainebleau Las Vegas Holdings, LLC

All these developments are even further highlighted by the recent decision of the United States District Court for the Southern District of Florida in the bankruptcy proceeding *In re Fontainebleau Las Vegas Holdings, LLC*, 2010 U.S. Dist. LEXIS 79519 (July 14, 2010). While at the time of this writing, the decision is on appeal to the United States Court of Appeals for the Eleventh Circuit, the current importance of this mechanics' lien-related decision cannot be overemphasized. Among other things, at issue in the case are hundreds of millions of dollars in mechanics' lien claims filed by a variety of contractors and material suppliers against the troubled Fontainebleau Las Vegas hotel, casino, convention center, spa, and retail shopping project, which holds a prominent location on the famed Las Vegas Strip, as well as an even greater sum in competing claims by banks and lenders involved in that project. While determinations over the ultimate first-priority position as between the lien claimants and the project lenders remain, the mechanics' lien provisions in Nevada permitted those claimants to assert that they were in a first-priority lien position against the development. For that reason, in this particular decision, the court concluded the bankruptcy court erred by not adequately protecting the financial interests of these mechanics' lien claimants while the bankruptcy court was allowing cash collateral and post-petition financing transactions to take place. Clearly, the decision shows the potential power to be wielded by a properly and timely filed and perfected mechanics' lien claim, even when a bankruptcy has affected the project.

given that the sub-subcontractor was not within the scope of the lien waiver already executed and on file. However, there is the possibility that following this court's analysis, as opposed to the trial court's, could create a problem if the pre–2006 amendments lien waiver is executed and properly on file but then a subcontract encompassed by the scope of the waiver is executed after January 1, 2007. Following the Superior Court's approach would invalidate the lien waiver protection for the owner and invalidate a previously executed agreement in the process, a very weighty proposition for a future court to consider.

Proceeding in a "traditional" fashion may lead a claimant outside the applicable lien law.

What also appear to be similarly pro-residential lien amendments were recently adopted in Missouri. *See* Mo. Ann. Stat. § 429.016 (West 2010). While these amendments added only one section to Missouri's existing mechanic's lien provisions, the body of the amendments is more than several pages long. These changes affect most, if not all, "residential real property" projects other than certain projects constituting repair, remodeling, or additions to owner-occupied residential property consisting of four units or less. Some of the features of these amendments include timing requirements on the filing of a "notice of rights," which is, under most circumstances, required for proceeding with any lien claim on the types of jobs within the coverage of the amendments and needs to be filed within time parameters specified in the amendments and before the conveyance of the property to a bona fide purchaser for value.

In addition, substitution of collateral provisions are set forth along with the assurance that any such substitution will not affect a claimant's potential liability for slander of title. Further, the new provisions include considerable new language on partial and final waivers of liens, the effect of those waivers, as well as penalties for failure to execute a full and unconditional waiver after payment in full on the given "residential real property" project. One section actually provides that an unconditional final waiver shall be valid "notwithstanding claimant's failure to receive any promised payment or other consideration."

Despite the individual variations of these amendments and determinations, it is clear that lien laws are going to gain more attention as potential vehicles for securing payment particularly while the current economic forecast remains uncertain and troubling. *See, e.g.*, *Mostardi-Platt Assoc., Inc. v. Czerniejewski*, 929 N.E. 2d 94 (Ill. App. 5th Dist. 2010) (environmental consulting firm's attempt to place a lien on a project failed when court determined environmental property evaluation performed for suitability of coal gasification project on site was not the type of improvement that would give rise to lien rights under Illinois's Mechanics Lien Act). Oftentimes, taking action relative to liens becomes more routine and is based upon past experience. However, with changes to these lien laws occurring with much more frequency, proceeding in such a "traditional" fashion may very well lead a claimant outside the applicable lien law and, consequently, beyond its protection. For that reason, remaining current on the latest developments is becoming even more critical.

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as set forth in the contract, there are no grounds for the owner to make a claim. Unfortunately, in the subsequent lawsuit, the court determines that the flooring system constituted "goods" within the meaning of the UCC, and your client is held liable for breaching an implied warranty because the owner relied on him to pick a system that was suitable for the facility's obvious purpose.

Under the UCC's broad definition, many if not most construction contracts will have at least some aspect dealing with the provision of "goods." U.C.C. § 2-105(1). If a transaction is mixed, involving the sale of both goods and services, courts have traditionally looked to the primary or predominant purpose of the transaction to determine whether article 2 applies.

For example, in *Bonebrake v. Cox*, 499 F.2d 951 (8th Cir. 1974)—one of the leading cases in the development of the "predominant purpose" test—a dealer in bowling equipment agreed to sell "used equipment" including lane beds, pin-spotting machines, under-lane ball returns, fiberglass seating, lockers, and even rental shoes to replace equipment the buyers' bowling alley had lost in an earlier fire. Before all the contract deliveries were complete, the seller died, and the buyers stopped paying.

After reviewing several cases that dealt with the applicability of article 2 to so-called mixed transactions like the one at issue, the *Bonebrake* court held:

> The test for inclusion or exclusion [from article 2] is not whether they are mixed, but, granting that they are mixed, whether their predominant factor, their thrust, their purpose, reasonably stated, is the rendition of service, with goods incidentally involved (e.g., contract with an artist for painting) or is a transaction of sale, with labor incidentally involved (e.g., installation of a water heater in a bathroom).

Id. at 960.

Under this test, the *Bonebrake* court determined that the transaction was predominantly a sale of goods, with the installation and setup of the various bowling machines being merely an incidental part of the transaction. Among the factors that the court emphasized were the circumstances and apparent purpose of the transaction. First, the court noted that the sale was prompted by the buyers' own loss of bowling equipment in a fire. For that reason, their purpose in the transaction was to replace all the goods that they had lost (including bowling balls and shoes), not to contract for any specialized services from the seller.

He had not built something new, "but rather simply assembled the product he was selling."

The *Bonebrake* court also relied heavily on the contract language used by the parties themselves. Of particular importance, the parties' written agreements referred to the transaction as being a sale of "used equipment" and warranted that such equipment would be free from "defects in workmanship and materials." "The language thus employed," reasoned the court, "is that peculiar to goods, not services."

In applying the "predominant purpose" test, courts in other jurisdictions have considered these and a variety of other factors in determining whether a mixed contract falls within article 2. In *Cober v. Corle*, 610 A.2d 1036 (Pa. Super. 1992), for instance, the court first looked at the parties' written contract but then also examined the nature of the delivered product itself before determining that article 2 governed the sale and erection of a pre-designed, pre-engineered metal building. On this second point, the *Cober* court emphasized that the metal building in question was essentially a pre-engineered "kit" that merely needed to be assembled. The court contrasted such work against typical construction services, which entail taking a wide variety of materials from a wide variety of sources and assembling them into something new and different. Here, the court found that the seller had not built something new, "but rather simply assembled the product he was selling."

In contrast to *Cober*, the court in *Harman v. Bonanza Buildings, Inc.*, 390 N.W.2d 536 (Neb. 1986), found that a contract to sell and erect a similar metal building constituted a construction services contract rather than a transaction in goods under article 2. There are a few facts that might serve to distinguish the two cases, but the *Harmon* court seemed not to acknowledge such facts in its rather summary determination that "the predominant purpose of the transaction was not to sell [plaintiff] the components for a building but, rather, to create a building for him."

Similarly, some courts rely on the parties' "intent," which is to be gleaned from their contract language and the purpose of the transaction. *Standard Structural Steel Co. v. Debron Corp.*, 515 F. Supp. 803 (D. Conn. 1980), is illustrative of such cases.

Other courts have focused on the product to be delivered in order to determine the predominant purpose of a transaction. In *Meeker v. Hamilton Grain Elevator Co.*, 442 N.E.2d 921, 923 (Ill. App. 1982), for instance, the court held that a "pile of steel pieces that have been cut and shaped to specified dimensions and angles" could be fitted together—like the various bowling alley components in *Bonebrake*—such that the contract in that case was predominately for the sale of grain bins rather than for their construction. Goods are goods "even

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though not yet assembled." On the other hand, the court in *Frommert v. Bobson Construction Co.*, 558 N.W.2d 239 (Mich. App. 1997), found that a contract for a replacement roofing system was predominantly for services because the contract required the removal and disposal of the existing roof in addition to the installation of a new roofing system.

Even the nature of the dispute giving rise to the suit has been used occasionally as one of the predominant purpose factors. For example, in *J.O. Hooker & Sons, Inc. v. Roberts Cabinet Co.*, 683 So. 2d 396 (Miss. 1996), a subcontractor agreed to remove and then either refurbish or install new kitchen cabinets at a public housing redevelopment site. As the work progressed, a dispute arose between the cabinetry subcontractor and the general contractor as to who was responsible for the disposal of the discarded cabinets that could not be refurbished. In resolving the case, the court explained that the question of who had the duty to dispose of the unsalvageable cabinets related directly to a portion of the subcontract dealing with services, thus the dispute was governed by general contract law. However, the court noted that it "would not hesitate to apply Article 2 if the present case involved, for example, a dispute over the quality of the cabinets. . . ."

While a case like *Bonebrake* may involve facts that are relatively clear-cut, the outcomes in other cases, like *Cober* and *Harmon*, are more troubling or, at least, less predictable. Notably, the "predominant purpose" test has not escaped criticism. In *Elkins Manor Associates v. Eleanor Concrete Works, Inc.*, 396 S.E.2d 463 (W. Va. 1990), for example, the court said, "[w]hat is often overlooked is that the UCC evolved from commercial sales where goods were often bought and sold without any extensive contract document spelling out the rights and remedies of the parties." Thus, the court reasoned, the underlying gap-filling purposes of the UCC are inapposite in the context of modern construction contracts, which "often contain[] detailed contract provisions and specifications."

As the foregoing makes clear, different jurisdictions place differing weights on the express terms of the contract, the surrounding circumstances, the relationship between the goods and services called for in the contract, the compensation structure, and other factors. Thus, even under a uniform act like the UCC, the construction practitioner should look closely at local precedent for article 2's potential application before jumping to what might, at first blush, seem to be the obvious answer.

The most dangerous pitfall may be the UCC's separate claims limitations period.

Statute of Limitations

The next focus should be on those areas of law where article 2 differs significantly from the general law of contract. One such area, and perhaps the most dangerous pitfall for the construction law practitioner, is the UCC's separate limitations period for claims. Consider the following hypothetical:

> Your ornamental steel fabricator client comes to you with a pile of unpaid invoices owed by a general contractor for railings, grate covers, and other similar goods supplied (and sometimes installed) by your client over the past eight years on state roadway projects. The client does not want to sue right away, and you are comfortable that the general 10-year breach of contract statute of limitations applies to the transactions. Eventually, you file suit. Unfortunately, you then have to explain to your client (and perhaps your carrier) that, in fact, the much shorter four-year UCC statute of limitations applies and that he has lost a substantial portion of his claim.

Prior to amendment in 2003, section 2-725(1) of the UCC provided that any action for breach must be brought within four years. *See* U.C.C. § 2-725 and official comments thereto. In 2003, this basic four-year limitation period was supplemented with a discovery rule that allows an action to be brought up to one year after a breach was or should have been discovered but not more than five years after the cause of action accrued.

Even with the new discovery rule, which has not been adopted in all UCC jurisdictions, the section 2-725 limitation period is significantly shorter than the limitation periods applicable in many states to contract claims generally. Thus, failure to recognize that a transaction is governed by the UCC can result, as it often has, in otherwise potentially valid claims being barred on timeliness grounds.

In *Wagner-Meinert, Inc. v. EDA Controls Corp.*, 444 F. Supp. 2d 800 (N.D. Ohio 2006), for example, the plaintiff contractor had been hired to design and install a refrigeration system. Sometime after the system was up and running, an alleged defect caused, or at least contributed to, a fire at the facility. The owner sued the general contractor, who in turn sued its subcontractor for breach, contribution, and indemnity. Applying the "predominant purpose" test, the court found that the subcontract was for the sale of goods based on a comparison of the relatively small value of the start-up and training services relative to the total subcontract price. On that ground, the court found that the general's claim was time-barred.

In *Ogden Martin Systems of Indianapolis v. Whiting Corp.*, 179 F.3d 523 (7th Cir. 1999), the Seventh Circuit upheld a district court's dismissal, on timeliness grounds, of claims arising out of the breach of a contract to

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build two 13-ton solid waste handling cranes. In the district court, the crane supplier argued that the UCC's four-year limitations period should apply, but the owner claimed that the cranes were an improvement to real property and thus the state's six-year statute for such claims should apply. Affirming the district court's dismissal of the case, the circuit court used what it called the "predominant thrust test." Weighing the various factors, the court concluded that the delivery and installation of the two cranes constituted a transaction in goods subject to the UCC's shorter limitations period.

Acceptance and Rejection

Article 2's provisions concerning acceptance and rejection are also a hazard for the practitioner who is unaware of the UCC's applicability. Consider the following hypothetical:

> Your mechanical contractor client landed a large project calling for, among other things, the installation of 160 fan coil units. The client orders the fan coil units from a reputable national manufacturer, and they are delivered to you client's on-site trailers. He notices that controls on the units are not exactly what were ordered, and he asks you what he should do. You figure that the manufacturer will step up and fix them later, especially because you can sue for breach of contract. Unfortunately, your client went ahead and installed the units, knowing about the nonconformity. Under the UCC, your client has accepted the goods and waived his right to reject the fan coil units.

The UCC contains detailed provisions concerning the acceptance of goods, their rejection, revocations of acceptance, and notices of breach. *See* U.C.C. § 2-601 et seq. Under article 2, a buyer may set aside a purchase if he or she properly rejects the goods or properly revokes his or her acceptance of them. Section 2-602(1) provides that the buyer has a duty to reject goods "within a reasonable time after their delivery or tender." Moreover, the buyer's rejection is ineffective unless the buyer "seasonably notifies" the seller.

If not rejected, goods are generally deemed accepted by default. "Acceptance" can occur, for example, whenever the buyer does any act inconsistent with the seller's ownership of the goods. U.C.C. § 2-606(1). Once acceptance has been given, it can be revoked only if the goods' nonconformity "substantially impairs" their value to the buyer and certain other conditions are met. U.C.C. § 2-608(1).

One must take heed of the possible application of article 2 in advising his or her clients.

If not properly revoked, acceptance of goods precludes their rejection. If acceptance is made with knowledge of a nonconformity, it cannot be revoked because of the known nonconformity unless "the acceptance was on the reasonable assumption that the nonconformity would be seasonably cured." U.C.C. § 2-607(2).

Once goods are accepted, and if acceptance is not revoked, the buyer must notify the seller of any breach "within a reasonable time." U.C.C. § 2-607(3)(a). The purpose of this rule is to give the seller an adequate opportunity to cure, minimize damages, negotiate a resolution that avoids litigation, or if all else fails, investigate the buyer's claims before the evidence becomes stale. *See, e.g.*, *Standard Alliance Industries, Inc. v. Black Clawson Co.*, 587 F.2d 813, 826 (6th Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

As in the context of limitations period issues, a practitioner must take heed of the possible application of article 2 in advising his or her construction industry clients regarding the rights and obligations that arise at the time of delivery under a "mixed" goods and services contract.

In *Midwest Builder Distributing, Inc. v Lord & Essex, Inc.*, 891 N.E.2d 1 (Ill. App. 2007), for example, a building supply distributor brought suit against a homebuilder after the homebuilder refused to pay for cabinets and appliances furnished under a series of subcontractor agreements. According to the agreements, the homebuilder's obligation to pay was conditioned on compliance with a "purchase order document system" that required subcontractors to submit "job release notices" at the time of each delivery. Citing the express terms of the subcontract agreements, the homebuilder claimed it had no duty to pay until the distributor submitted the required release notices. Although the court agreed that the common law ordinarily requires "strict compliance" with such conditions, it found that the subcontract agreements were predominantly for the sale of goods and thus governed by the UCC. Applying article 2, the court found that the homebuilder had "accepted" the goods by keeping them and building them into houses, some of which it had already sold—actions clearly "inconsistent with the seller's ownership." Given this acceptance, the homebuilder had lost whatever right it might otherwise have had to withhold payment.

The results of a similar failure to consider the UCC can be seen in *Heating & Air Specialists, Inc. v. Jones*, 180 F.3d 923 (8th Cir. 1999), a suit arising after a national air conditioning manufacturer terminated one of its local franchisees. There, the plaintiff franchisee claimed that Lennox, the defendant manufacturer, had wrongfully terminated its franchise in violation of the parties' agreement. Based on the wrongful termination and other breaches, the plaintiff argued that it was excused, under general contract law principles, from making

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payments that otherwise would have been due. However, the court nevertheless agreed with Lennox because it found that the transaction at issue was fundamentally an "exchange of goods" governed by the UCC.

Express and Implied Warranties

Article 2 also has specific warranty provisions, many of which are implied and thus operate unless expressly disclaimed. Consider the following hypothetical:

> In the course of work on a large school renovation project, your electrical subcontractor client purchases transformers and auxiliary power units from a supplier he had not dealt with before. Under the contract documents, your client is required to provide certain express warranties for such equipment, a term that you had advised him to accept based on the assumption that, if something went wrong, he would always be able to force the supplier to stand behind its products. Two and a half years after the project is complete, your client is called upon to repair or replace the defective power units. Only after you have begun pursuing the original supplier in connection with the defects do you realize that the supplier's terms of sale included expansive warranty waivers—the units were sold to your client "as is."

If a transaction is governed by article 2, the seller may be liable for express and implied warranties that differ from what he or she might have intended or anticipated under the common law of contracts.

Under article 2, express warranties can arise from any affirmation, description, sample, or model of the goods. U.C.C. § 2-313(2). As the Official Comments explain, the precise timing of the affirmation or description may not be material. Rather, "[t]he sole question is whether the language or samples or models are fairly to be regarded as part of the contract." U.C.C. § 2-313 cmt. 9.

Moreover, the seller does not have to use formal words such as "warrant" or "guarantee" to create an express warranty. U.C.C. § 2-313(3). However, "an affirmation merely of the value of the goods or a statement purporting to be merely the seller's opinion or commendation of the goods does not create a warranty." *Id.*

Generally, if the seller is a "merchant" within the meaning of the code, the contract for sale also includes an implied warranty of merchantability. U.C.C. § 2-314(1); *see also* U.C.C. § 2-104 (defining a "merchant" as "a person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction. . . ."). While the implied warranty of merchantability can be modified or waived, the language used to do so must mention merchantability or use such expressions as "no warranties," "with all faults," or "as is." U.C.C. § 2-316(2)–(3). In the case of a "consumer contract," exclusion must be even more explicit. *See* U.C.C. § 2-316(2).

All areas where article 2 diverts from the common law of contracts carry a potential for surprise.

Article 2 also imposes an implied fitness for a particular purpose "[w]here the seller at the time of contracting has reasons to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods." U.C.C. § 2-315.

Application of such rules can be seen in *Mennonite Deaconess Home & Hospital, Inc. v. Gates Engineering Co.*, 363 N.W.2d 155 (Neb. 1985). There, a hospital contracted with an elastomeric roofing supplier to replace the hospital's roof. During the initial meeting between representatives of the hospital and the supplier, the hospital was given advertising brochures about the "roofing system." Even though the supplier, as a result of the contractor's incorrect installation, refused to issue its standard 10-year warranty, the hospital nevertheless sued for breach of express and implied warranties under article 2. After the court determined that article 2 applied, the court found a breach of express warranties based on statements in the advertising brochure.

The court then turned to the question of implied warranties under the UCC. Here, the court reiterated that the good in question was a complete "roofing system." For that reason, the contractor's failure to correctly install *the system* constituted a breach of the supplier's implied warranties of merchantability and fitness, even though the roofing materials themselves were not defective. Thus, even though all the breaches occurred with respect to the services portion of a mixed contract, because those services were deemed incidental to what was predominantly a transaction in goods, the breaches gave rise to express and implied warranty claims under the UCC.

Conclusion

Of course, there are many other areas—the battle of forms and obligations to remote purchasers under section 2-313B come to mind—in which article 2 establishes the rights and obligations of parties to a transaction in goods. All areas where article 2 diverts from the common law of contracts carry a potential for surprise for the construction law practitioner. Forewarned is forearmed.

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Penalties for Contractors

continued from front cover

who is a "contractor" under California's licensing law becomes complex when considering modern building relationships and different legal entities. In addition, the question of who qualifies for the "owner-builder" exception requires careful examination.

The lack of, or lapse in, a valid license may require return of all compensation paid to the contractor. Indeed, there are many technical rules for which a violation may result in license suspension. Moreover, the lack of a valid license at any time during performance of work may form a complete defense to any type of legal action seeking to recover compensation for the work. The rule applies even where the owner knows beforehand that the contractor was unlicensed. *Hydrotech Systems, Ltd. v. Oasis Waterpark*, 52 Cal. 3d 988, 997 (Cal. 1991).

Why Is a License Required?

"The purpose of the licensing law is to protect the public from incompetence and dishonesty in those who provide building and construction services." *Id.* at 995, *citing Lewis & Queen v. N.M. Ball Sons*, 48 Cal. 2d 141, 149–50 (Cal. 1957). "The licensing requirements provide minimal assurance that all persons offering such services in California have the requisite skill and character, understand applicable local laws and codes, and know the rudiments of administering a contracting business." *Id.*

Because of the strength of this public policy, the law applies regardless of injustice to the unlicensed contractor. The statutes represent "a legislative determination that the importance of deterring unlicensed persons from engaging in the contracting business outweighs any harshness between the parties." *Id.* As a result of this philosophy, even a small lapse in licensure during construction may prevent recovery of all compensation due the contractor, not just a portion of it. *MW Erectors, Inc. v. Niederhauser Ornamental and Metal Works Co., Inc.*, 36 Cal.4th 412, 426 (2005).

Who Must Be Licensed?

The term "contractor" is synonymous with the term "builder" and is broadly defined to include any person who undertakes to, or does himself or herself, or by or through others, construct, alter, repair, improve, or demolish any building, road, or other improvement. Cal. Bus. & Prof. Code § 7026. All contractors must be licensed.

The business of contracting is broadly defined and highly regulated in California.

In *Vallejo Development v. Beck Development*, 24 Cal. App. 4th 929 (Cal. Ct. App. 1994), a master developer sold residential tracts to merchant builders under purchase agreements that required the master developer to construct infrastructure. The court held that the master developer acted in the capacity of a contractor with respect to completing the improvements. The fact that the master developer retained a licensed general contractor to construct the infrastructure was irrelevant.

Conversely, in *Fifth Day, LLC v. James P. Bolotin*, 172 Cal. App. 4th 939 (Cal. Ct. App. 2009), a construction manager performing services under a development management agreement was held not to be a contractor. In that case, the owner separately retained a general contractor to perform construction. After carefully reviewing the obligations of the development management agreement, the court held the construction manager had not undertaken any construction activities. *Id.* at 948.

A subcontractor is a contractor for purposes of the licensing law. Cal. Bus. & Prof. Code § 7026. It is important to note that the contractor must have the proper license classification to perform the particular trade or work. *See MW Erectors*, 36 Cal. App. 4th at 431–34; *Currie v. Stolowitz*, 69 Cal. App. 2d 771 (Cal. Ct. App. 1959); Cal. Bus. & Prof. Code § 7055. Even an unlicensed engineer who provides design services to improve a building is a contractor. *Banis Restaurant Design, Inc. v. Serrano*, 134 Cal. App. 4th 1035, 1046 (Cal. Ct. App. 2005). By contrast, a mere material supplier is not a contractor under the license law. Cal. Bus. & Prof. Code §§ 7045, 7052. And a surety is not required to have a license in circumstances where it hires a licensed contractor. Cal. Bus. & Prof. Code § 7044.2; *see General Insurance Co. of America v. St. Paul Fire & Marine Insurance Co.*, 38 Cal. App. 3d 760 (Cal. Ct. App. 1974).

Finally, there are myriad legal entities that may or may not be able to hold a valid license, such as a corporation, partnership, joint venture, and limited liability company. Careful attention must be given to ensure that the contractor entity is properly licensed to avoid illegality.

What Is the Owner-Builder Exception?

The law contains a significant exception to the licensing requirements for owners-builders. Cal. Bus. & Prof. Code § 7044. An owner-builder is exempt if he or she builds or improves a structure on his or her property provided that none of the improvements are intended for sale and the owner personally performs the work or the work is performed by his or her employees. Cal. Bus. & Prof. Code § 7044(a)(1). Proof of sale or offering for sale within one year creates a rebuttable presumption that the structure was undertaken for sale. Cal. Bus. & Prof. Code § 7044(b)(1). The presumption is conclusive where five or more structures are sold or offered for sale in one year. Cal. Bus. & Prof. Code § 7044(b)(2).

Alternatively, an owner-builder can be someone who directly contracts with licensees who are duly licensed to contract for the work of

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the respective trades involved, and, for projects involving single-family residential structures, no more than four are intended for sale in a calendar year. Cal. Bus. & Prof. Code § 7044(a)(2). The latter provision does not apply if the owner contracts with a general contractor. Cal. Bus. & Prof. Code § 7044(a)(2)(B). In the case of a homeowner improving his or her principal residence, there is an exemption for improvements to the residence or appurtenance, provided the work is performed prior to sale, the homeowner resides in the residence 12 months prior to completion of the work, and the homeowner has not availed himself or herself of the exemption on more than two structures during any three-year period. Cal. Bus. & Prof. Code § 7044(a)(3).

In *Ranchwood Communities Limited Partnership v. Jim Beat Construction Co.*, 49 Cal. App. 4th 1397 (Cal. Ct. App. 1996), developers of residential tracts, who were not licensed general contractors, subcontracted construction of numerous homes to various trades. Subsequently, homeowners sued for construction defects and developers cross-complained against subcontractors based on contract and indemnity theories. Subcontractors filed motions for summary judgment against the developers, arguing that they were not licensed contractors. In response, developers argued they were exempt owner-builders. The court was not persuaded that developers qualified as owner-builders by performing their own work or hiring licensed subcontractors. Citing a 1989 amendment, the court found the developers were not owner-builders exempted by the statute. *Id.* at 1415–16.

Whether the exception applies to commercial owner-builders is less clear because the statute has been amended several times. In an opinion by then-Attorney General Stanley Mosk, the 1961 version of the statute was found not to apply to hotels and commercial tenants, but did exempt commercial buildings constructed for occupancy by the owner. In reaching this conclusion, Attorney General Mosk reasoned as follows:

> The apparent purpose of the exemption provided by section 7044 was to strike a balance between the need for governmental regulation and freedom to deal with one's own property without unwarranted governmental interference. Under such circumstances, it is reasonable to assume that the Legislature sought to deny application of the exemption to owners constructing large motels, apartments, hotels and like buildings, while at the same time preserving the exemption to owners constructing buildings containing not more than three dwelling units, one of which would be resided in by such owner.
>
> 40 Op. Cal. Att'y Gen. 128 at 5 (1962).

When Must a Contractor Be Licensed?

A contractor must be licensed at the time the construction contract is entered into. Failure to hold a license at the time the contract is entered into subjects the unlicensed contractor to various penalties and may make the contract voidable. Moreover, the contractor must be licensed at all times during the performance of the work in order to recover compensation for the work. *MW Erectors*, 36 Cal. App. 4th at 425–30.

The judicial doctrine of substantial compliance is not a defense for failure to hold a valid license. Instead, the statute creates a very limited exception in circumstances in which the contractor was licensed before performance, acted reasonably and in good faith to maintain the license, did not know the license was no longer in effect, and acted promptly to reinstate once it learned that the license was invalid. Cal. Bus. & Prof. Code § 7031(e).

What Are the Penalties for an Unlicensed Contractor?

Criminal penalties may be imposed against contractors who are unlicensed. Performing construction without a license constitutes a misdemeanor, with penalties increasing for repeat offenders. Cal. Bus. & Prof. Code § 7028.

On the civil side, there are significant sword and shield penalties imposed on an unlicensed contractor. The shield aspect of the law prevents a contractor from recovering compensation for any work performed if the contractor is unlicensed at any time during the performance of the work. Cal. Bus. & Prof. Code § 7031(a). Case law interprets "compensation" broadly to include not only damages based on breach of contract but also any theory of affirmative recovery, including quantum meruit, foreclosure of a mechanic's lien, and even fraud. However, an unlicensed contractor may seek to offset amounts otherwise due. *S&Q Construction Co. v. Palma Ceia Development Co.*, 179 Cal. App. 2d 364, 371 (Cal. Ct. App. 1960).

This defense has been applied not only to disputes between owner and contractor but also to disputes in all tiers in the construction process, including disputes between general contractors, subcontractors, and sub-subcontractors. Thus, a general contractor may recover on a mechanic's lien against an owner but only after deduction of amounts due an unlicensed subcontractor. *Holm v. Bramwell*, 20 Cal. App. 2d 332 (Cal. Ct. App. 1937). However, the shield will not prevent enforcement of indemnity obligations owed to an unlicensed contractor. *UDC-Universal Development, L.P. v. CH2M Hill*, 181 Cal. App. 4th 10, 26 (Cal. Ct. App. 2010).

To seek redress in court, the contractor must allege a valid license to recover compensation. Once the issue is raised, the burden is on the contractor to prove valid licensure. Cal. Bus. & Prof. Code § 7031. An unlicensed contractor cannot avoid the law by pursuing arbitration. *Loving & Evans v. Blick*, 33 Cal. 2d 603 (Cal. 1949).

The sword aspect of the law allows a person who used an unlicensed contractor to recover all compensation paid to the contractor. Cal. Bus. & Prof. Code § 7031(b). Courts

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broadly interpret the disgorgement remedy to encompass situations in which a licensed contractor had its license technically suspended while the work was in progress.

For example, in *Wright v. Issak*, 149 Cal. App. 4th 1116 (2007), a contractor who had not paid its workers' compensation insurance sued a homeowner for unpaid work. Relying on a statute that automatically suspended the contractor's license for failing to obtain required insurance, the court held that the contractor could not recover any amounts from the owner, and the owner could recover all amounts paid to the contractor. *Id.* at 1122.

In *Oceguera v. Cohen*, 172 Cal. App. 4th 783 (Cal. Ct. App. 2009) and *White v. Cridlebaugh* 178 Cal. App. 4th 506 (Cal. Ct. App. 2009), homeowners successfully recovered compensation paid to contractors who had not complied with technical requirements for their responsible managing officer or employee. The courts found the technical violations resulted in the contractors' being unlicensed during the performance of the work. In perhaps its most forceful application, a homeowner in *Goldstein v. Barak Construction*, 164 Cal. App. 4th 845 (Cal. Ct. App. 2008), successfully obtained a writ of attachment against a contractor and an order preventing disposition of the contractor's residence. In that case, the contractor did not obtain his license until several months after the work commenced.

Conclusion

The business of contracting is broadly defined and highly regulated in California. Once a contractor's license is obtained, it must be properly maintained because of exposure to significant penalties for lapse or suspension. Using California as an example, lawyers should understand the laws in their jurisdiction whenever an issue of licensure is raised because the exposure to penalties may be substantial.

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