



OPINION

How contractors can avoid disgorgement

By Elizabeth Lawley and Zachary Price • Aug. 23, 2017

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Editor's Note: The following is a guest contribution from Elizabeth Lawley, a partner at Haight Brown & Bonesteel (HBB) LLP, and Zachary Price, an associate at HBB.

The recession was not an easy time for anyone in the construction industry. Hard choices were made, and weathering the recession forced companies to work hard while finding ways to pay the bills with much tighter cash flows. As the phones stopped ringing and jobs under contract were scaled back or put on hold, entire staffs were let go, offices were closed and income streams dried up. Lines of credit to fund short-term working capital needs became difficult to obtain or disappeared completely. In certain situations, the practice of tightening operations exposed companies to laws and regulations with harsh penalties.

One of those laws and regulations is disgorgement. In legal terms, it is the act of giving up something on demand or by legal compulsion. In practice, it means a contractor may be forced to give back profits from a project or, in certain circumstances, return all amounts paid to the contractor for the entire project. Imagine entering into a contract with a client to build a new house, performing all the work and receiving payment, only to have to give all that money back to the client. That is disgorgement.

One way a contractor could get hit with disgorgement is by performing contracting services without a valid license.

California, in particular, has tough civil and criminal penalties for unlicensed contractors. Those include misdemeanor charges for contracting without a license. A second offense is a \$4,500 minimum fine and 90-day jail time, one-year imprisonment and/or a \$10,000 fine for intentional use of another's license with intent to defraud, and a civil penalty of \$200 per day per employee performing work for an unlicensed contractor. These penalties were put into place to protect consumers against dishonest practices and incompetence, and the courts are required to enforce the harsh penalties.



Elizabeth Lawley

Disgorgement, however, may be the most severe penalty on the books. Contractors should take care to recognize the situations where this penalty comes into play and seek to avoid them. Cases involving recession-era projects that deal with these situations are currently prevalent in the courts. The following three situations commonly result in disgorgement.

Situation No. 1

As most construction professionals in California know, any person engaged in the business of a contractor, or that acts in the capacity of a contractor, must be properly licensed. Contractors performing work without a license are subject to disgorgement. This is the easiest situation for a contractor to avoid. A contractor must be licensed during the entire time in which it performs the contractual work, and contractors who start projects prior to obtaining a contractor's license can face disgorgement even if they are licensed by the end of the project.

Although the proposition that a contractor must be properly licensed seems straightforward, a contractor with an otherwise valid license can be deemed unlicensed in certain circumstances, leaving the contractor vulnerable to being hit with disgorgement. Those circumstances are the subject of the next scenario.

Situation No. 2

Disgorgement can befall the unwary contractor who lets workers' compensation insurance lapse, has inadequate insurance or improperly characterizes employees as independent contractors. During the recession, costs such as workers' compensation insurance were a burden that some contractors sought to minimize.

With employees being let go, some contractors allowed their workers' compensation insurance to lapse and failed to re-obtain it when an uptick in business led to hiring more employees. Some contractors sought to minimize insurance costs by understating the number of employees they had when applying for insurance. Other contractors hired workers as independent contractors in an attempt to avoid insurance altogether.



Zachary Price

In California, the lack of workers' compensation insurance, or even an inadequate amount of insurance, invalidates a contractor's license immediately. No notice to the contractor is required. A contractor without insurance or enough insurance is considered unlicensed from that moment on and may not even know it. That can be a scary thought.

In several recent cases involving recession-era contracts, contractors have been forced to repay all sums paid by the client after it was discovered that they lacked adequate insurance and/or misstated the number of employees working for them. Maintaining workers' compensation insurance in the appropriate amount is important.

Situation No. 3

A third situation that can result in disgorgement involves the amount and timing of payments made under a residential home-

improvement contract. As it pertains to residential construction in California, it is against the law for a contractor to collect payment for work not yet completed or for materials not yet delivered; a contractor may require a down payment that may not exceed \$1,000 or 10% of the contract price, whichever is less. These rules are taken so seriously that they are required to be included in most residential contracts in at least 12-point boldface type.

However, with lines of credit drying up or vanishing completely during the recession, obtaining enough funds to purchase materials for projects was a challenge, and some contractors sought to cut corners by demanding a larger down payment and requesting payment for work not yet completed.

Were the relationship to sour and result in a lawsuit, the client could then use the improper down payment or request for payment for work not completed as powerful ammunition against the contractor. Disgorgement is one of the client's remedies in such a situation. Even though it can be difficult to do during a credit crunch, following the rules governing the timing of payments and down payment limits can save residential contractors much heartache in the long run.

No one wants to complete a project only to give the entire contract price back to the client, but the law has made that penalty available in certain situations. With the recession in the rearview mirror, the tactics some businesses took to tighten operations may not be as prevalent, but contractors should be aware of the harsh consequences should a decline in business result in hard decisions being made once again.