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Message from the Editor:

In this edition of *Under Construction*, we will discuss three current issues about which contractors and others in the construction industry should be aware. First, potential harsh penalties in the state of California make it imperative that California contractors ensure they are properly licensed at all times. We will address the narrow exception, and what this means. Second, we will discuss whether or not arbitration clauses preclude administrative complaints, based on a recent U.S. Supreme Court case. Finally, we will address a very recent decision by the Nevada Supreme Court that pay-if-paid clauses are unenforceable. These topics can serve as a reference to provide awareness of legal updates in the construction industry throughout our regional practice area.

Please note, a previous newsletter regarding the enforceability of pay-if-paid clauses in all of our office locations was distributed in June 2007. The Nevada portion of that newsletter must be replaced by the analysis set forth in the Nevada pay-if-paid article in this newsletter. If you would like to receive a copy of the June 2007 newsletter, please contact Jim Sienicki at 602.382.6351 or jsienicki@swlaw.com.

Under Construction is provided as a service to highlight legal trends and issues commonly faced in the construction industry. Please contact us if you have any questions or suggestions. Let us know how we can improve this publication to provide added value to you.

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Beware of Harsh Penalties for Unlicensed Contracting in California

By Stuart Einbinder and Jeff Singletary

California has some of the toughest penalties in the country for unlicensed contractors. Among other things, a contractor who is not properly licensed "at all times" during "the performance of any act or contract where a license is required" may not pursue an action to recover compensation for work performed. Moreover, any person who utilizes an unlicensed contractor may bring an action to recover all compensation paid to the unlicensed contractor, thereby getting the construction services for free. Although these penalties may seem draconian in some circumstances, California courts have concluded that they represent "a legislative determination that the importance of deterring unlicensed persons from engaging in the construction business outweighs any harshness between the parties."

In order to soften the harshness of this law, California Business & Professions Code section 7031 sets forth a "substantial compliance" exception for a contractor who unknowingly is unlicensed during performance. The exception applies only if the contactor (1) was duly licensed prior to performance, (2) acted reasonably and in good faith to maintain proper licensure, (3) did not know, or reasonably should not have known, he or she was not duly licensed, and (4) acted promptly and in good faith to restore his or her license upon learning it was invalid.

However, two recent California Court of Appeal decisions highlight the broad scope of the penalties for unlicensed contracting and the narrowness of the substantial compliance exception.

In *Great West Contractors, Inc. v. WSS Industrial Construction, Inc.*, a subcontractor sued a general contractor to recover compensation for work performed. The subcontractor's president held a valid individual license. However, at the time of bidding, the subcontractor had applied for but not yet obtained a license. A few months later the subcontractor signed a subcontract, and about ten days later it obtained a license. Only thereafter did the general contractor execute the subcontract. Prior to obtaining its license, the subcontractor prepared shop drawings and ordered some materials in furtherance of its work on the project.

Based upon these facts, the general contractor moved for nonsuit because the subcontractor was not licensed "at all times." The trial court rejected the motion because the president held a valid license, and also because it concluded licensure was not required for the tasks performed. The court of appeal disagreed, making several important rulings. First, the court held that the "statute applies whether or not a party is operating under an executed contract when performing tasks that require licensure." Thus,

it made no difference that the subcontract had not yet been executed by both sides. Second, the court concluded that preparing shop drawings and ordering materials were tasks for which a license was required. Finally, the court found that the substantial compliance exception was not applicable because the subcontractor was "never licensed before it commenced work," and the subcontractor could not rely upon the license of its president.

In *Wright v. Issak*, a contractor sued various homeowners to recover compensation for work performed. Under the workers compensation laws, the failure to obtain workers' compensation insurance results in an automatic suspension of a license. The contractor had a valid license, but due to underreporting of payroll records, its license was automatically suspended by operation of law. The homeowners raised the suspension as a defense to the action and also sought reimbursement of all prior payments made to the contractor for work performed. The contractor's underreporting of payroll was "not inadvertent," so the contractor was not a sympathetic party acting in good faith. Nonetheless, the contractor claimed it had no knowledge of the suspension. Unfortunately for the contractor, lack of notice was not a defense. Since the license was automatically suspended by operation of law, the contractor was not properly licensed at all times. Therefore, the contractor could not recover on its suit and had to return to the homeowners all amounts paid for work performed.

Given the dire consequences of being unlicensed, California contractors need to ensure they are properly licensed at all times. The substantial compliance exception may protect an unwary contractor when a paperwork snafu or other inadvertent mistake causes a license to lapse for a short time period, but the exception is narrow and will be strictly construed. Accordingly, California contractors are strongly advised to closely monitor compliance and ensure there are no lapses.

A New Weapon for Contractors - Does Your Arbitration Clause Preclude Administrative Complaints?

By Jim Sienicki and Mike Yates

State and federal courts, faced with overcrowded dockets, have consistently upheld contractual arbitration provisions. Indeed, the Federal Arbitration Act (the FAA), originally passed by Congress in 1925, explicitly upholds the validity of all arbitration agreements involving interstate commerce notwithstanding any state law to the contrary. Arbitration clauses are common in construction contracts – in fact, the standard AIA form contract (A201), § 4.6.1 (1997) states that "[a]ny claim arising out of or related to the contract…shall…be subject to arbitration."

Moreover, courts typically rule that construction contracts involve "interstate commerce" if architects, engineers, contractors, materials, bidders, bonds, or any other significant aspect of the Project is located in a state other than where the project is located. *See, e.g., Shepard v. Edward Mackay Enterprises, Inc.*, 148 Cal.App.4th 1092 (3d Dist. 2007); *Southern Oklahoma Healthcare Corporation v. JHBR-Jones-Hester-Bates-Riek, Inc.*, 900 P.2d 1017 (Ct.App.1995).

Despite judicial and legislative support for arbitration, contractors often face state administrative actions (typically filed with the local Registrar of Contractors, building departments, or state contractors boards) brought by irate owners, general contractors, or subcontractors. However, a new United States Supreme Court decision may expand the power of arbitration clauses to administrative actions even if state statutes mandate that an administrative agency has exclusive jurisdiction over particular issues (such as licensing, workmanship, and payment issues). Accordingly, a strong argument now exists that issues traditionally left to an administrative law judge or agency head must be decided by an arbitrator if the parties' contract calls for arbitration.

This new decision, *Preston v. Ferrer*, arose from a California employment dispute between the afternoon television personality "Judge Alex" Ferrer and his talent agent Arnold Preston. Preston claimed that Ferrer owed him fees pursuant to his agency contract, which contained an arbitration clause. Ferrer countered that Preston was an unlicensed agent, was not entitled to recover under the agency contract, and that arbitration did not apply because California statutes stated that the Labor Commissioner had exclusive jurisdiction. The U.S. Supreme Court held that public policy strongly favors arbitration and that parties who agree to arbitrate all disputes also agree to arbitrate the validity of the underlying contract – including, in this case, whether the agent was appropriately licensed. Thus, the U.S. Supreme Court held that the Federal Arbitration Act trumped California statutes and that an arbitrator, not the Labor Commissioner, would decide if Preston was appropriately licensed (and determine the validity of the agency contract).

How does this decision affect you? First, many (if not most) contractors have entered into contracts at one time or another containing a binding arbitration clause. Based upon *Preston*, contractors who face administrative actions filed by angry owners, general contractors or subcontractors with a Registrar of Contractors, state licensing or contracting board, or building department can now argue that these actions should be stayed or dismissed since the administrative action conflicts with the parties' arbitration clause. In addition, contractors can now argue that arbitrators (not administrative law judges or commissioners) should decide factual questions related to issues traditionally left to administrative agencies, including issues pertaining to payment, licensing, and/or defective workmanship. While state administrative agencies will still retain the authority to discipline a contractor's license, parties who previously agreed to arbitrate but later file administrative complaints seeking an affirmative recovery may find their administrative complaints stayed or dismissed,

and that they will have to pursue the matter in arbitration.

In sum, while the impact of *Preston* is uncertain given the recent nature of the decision, it appears likely that contractors and subcontractors have a new tool to fight owners, general contractors and subcontractors who attempt to sidestep arbitration clauses by filing administrative complaints or who attempt to use administrative proceedings to gain leverage by making claims that affect the contractor's license.

Nevada Supreme Court Rules Pay-If-Paid Clause Unenforceable

By Leon F. Mead II, Esq.

The Nevada Supreme Court has struck down pay-if-paid contract provisions as violating Nevada public policy. In *Lehrer McGovern Bovis, Inc. v. Bullock Insulation, Inc., et al.,* 124 Nev. Adv.Op. 39 (June 2008), the project owner and an out-of-state general contractor used a poorly worded waiver of the subcontractor's mechanics lien right in conjunction with a pay-if-paid provision to attempt to argue that neither had an obligation to pay the subcontractor for its work. The trial court concluded "that the pay-if-paid provision was unenforceable as a matter of public policy because '[i]t deprives people who work on construction projects of a statutory right' to a mechanics lien." On appeal, the owner and general contractor argued that the trial court erred by holding both the mechanics lien waiver clause and the pay-if-paid clause unenforceable; the Supreme Court disagreed.

Mechanics Lien Waivers Must Be Reviewed on a Case-By-Case Basis

The project owner's argument was the mechanics lien waiver provision did not violate Nevada public policy and therefore the trial court was in error. The Supreme Court, noting that the Nevada Legislature had made contractual mechanics lien waivers void and unenforceable in 2003, disagreed and held that trial courts must review each mechanics lien waiver on a case-by-case basis to determine whether the waiver violates public policy. The Court reasoned that:

> *A contractor has a statutory right to a mechanics lien for the unpaid balance of the price agreed upon for labor, materials and equipment furnished. 'The object of the lien statutes is to secure payment to those who perform labor or furnish material to improve the property of the owner.' This court has held on numerous occasions 'that the mechanics lien statutes are remedial in character and should be liberally construed.…*
>
> *[W]e now … conclude that it is appropriate for the district court to engage in a public policy analysis particular to each lien waiver provision that the court is asked to enforce. In doing so, we emphasize that not every lien waiver provision violates public policy. The enforceability of each lien waiver clause must be resolved on a case-by-*

> *case basis by considering whether the form of the lien waiver clause violates Nevada's public policy to secure payment for contractors.*
>
> *In this case, the lien waiver provision applies regardless of whether [the subcontractor] received any payment. We conclude that such a provision violates public policy, as it fails to secure payment for [the subcontractor].*

Lehrer, supra, 124 Nev.Adv.Op. at 15-17.

First, by creating a "public policy to secure payment for contractors," the Nevada Supreme Court seems to have created significant barriers to challenge a mechanics lien's validity for technical errors or omissions in the mechanics lien statutory scheme. This would seem to violate the Nevada Legislature's directive that *"Except as otherwise provided in NRS 108.221 to 108.246, inclusive, a person may not waive or modify a right, obligation or liability set forth in the provisions of NRS 108.221 to 108.246, inclusive."* NRS 108.2453(1). If there is a public policy to secure payment for contractors, does the failure of the contractor to serve the mandatory "Notice to Owner of Right to Lien" under NRS 108.245 violate public policy, rendering the statute unenforceable?

Second, since the effect of any mechanics lien waiver, including those set forth in NRS 108.2457(5), is to waive mechanics lien rights, can any such waiver given without corresponding payment be valid? Current Nevada mechanics lien statutes seem to disallow such a situation (*see* NRS 108.2457(2)(a)), but even if the Legislature were to change the law to make an unconditional waiver and release actually mean what it says, does the Court's ruling here render such laws unenforceable?

Pay-if-Paid Provisions are Unenforceable as Violating Public Policy

Having dealt with the mechanics lien waiver issue and having created a new public policy to secure payment to contractors, the Nevada Supreme Court turned to the general contractor's argument that the pay-if-paid provision should have been enforceable. With no more analysis of pay-if-paid provisions than one paragraph, the Court struck them down seemingly without exception:

> *At the time the parties entered into the agreement and subcontract, the Legislature had not yet proclaimed pay-if-paid provisions unenforceable [fn 33: We note that in 2001, the Legislature amended NRS Chapter 624 to include the prompt payment provisions contained in NRS 624.624 through NRS 624.626, which make pay-if-paid provisions entered into subsequent to the Legislature's amendments unenforceable…], and this court had not previously addressed the enforceability of such provisions. Because a pay-if-paid provision limits a subcontractor's ability to be paid for work already performed, such a provision impairs the subcontractor's statutory right to place a mechanic's lien on the construction project [fn 34: See Wm. R. Clarke Corp.[v. Safeco Ins., 938 P.2d 372] at 376 [(Cal., 1992)] (concluding that a pay-if-paid provision 'has the same practical effect as an express waiver of [mechanics lien] rights).] As noted above, Nevada's public policy favors securing payment for labor and material contractors. Therefore, we conclude that pay-if-paid provisions are unenforceable because they violate public policy.*

Lehrer, *supra*, 124 Nev.Adv.Op. at 18.

Let's evaluate the Nevada Supreme Court's analysis. First, the Nevada Legislature *did not* proclaim pay-if-paid provisions unenforceable in NRS 624.624 through NRS 624.626. In fact, NRS 624.626(1)(b) expressly recognizes that a subcontractor may stop work *"even if the higher-tiered contractor has not been paid and the agreement contains a provision which requires the higher-tiered contractor to pay the lower-tiered subcontractor only if or when the highertiered contractor is paid."* Nothing, in either the legislative history of NRS 624.624 through 624.626, or in the statutes themselves, indicate that a pay-if-paid provision is invalid. Since the Court's opinion expressly states that it was not necessary to make such a ruling to decide its case (*See Lehrer, supra*, 124 Nev.Adv.Op. at 18, fn. 33), it is difficult to understand why the Court would nevertheless make such a statement. This casual remark will nevertheless have significant practical effect on thousands of cases and transactions throughout this state.

Second, not all pay-if-paid clauses eliminate a subcontractor's right to a mechanics lien. There is no reason in the world that a subcontractor cannot agree that a general contractor's obligation to pay the subcontractor is contingent upon the general contractor being paid by the owner, while still preserving to the subcontractor his mechanics lien rights. All that is necessary is careful drafting of the subcontract agreement.

Third, the Court's decision ignores the corresponding right of a general contractor to secure payment from the owner, and the unreasonable burden placed on that contractor to have to pay subcontractors regardless of the owner's payment. Under the Supreme Court's ruling here, the general contractor becomes a *de facto* lender to the owner for the work of improvement. Further, the opinion does not deal with the situation when a lender decides not to fund the owner of a project for the contractor's work. The lender can still foreclose on the project, rendering the general contractor's mechanics lien invalid, but requiring the general contractor to pay the subcontractor. Whether the unpaid general contractor would have a claim for unjust enrichment against the lender has not been determined by the Nevada Supreme Court.

Fourth, Nevada is not California. Nevada's mechanics lien law is substantially different than that in California. California has a mechanics lien right that is guaranteed under the state's constitution. *Cal. Const., Art. 14, § 3*. There is no such corresponding *constitutional* right to a mechanic's lien in Nevada. As such, the Nevada Mechanics Liens should be strictly applied according to the rules of the legislative enactment- NRS 108.221 through 108.246. While these rules may be liberally construed to effect their purpose, the Nevada Supreme Court should not merely apply California law to Nevada mechanics lien statutes. The Court's citation to the 1992 case of *William R Clarke Corp. v. Safeco Ins.*, 938 P.2d 372 (Cal.1992), is the perfect example. Unlike Nevada's Supreme Court which concludes that "not every lien waiver provision violates public policy," this California case expressly states that any lien waiver other than those provided for by statute *does* violate California's constitutional right to a mechanics lien and is, therefore, void.

Fifth, unlike California, the Nevada Supreme Court has held that even if a mechanics lien is

not available, a subcontractor has a right to a claim against the owner for unjust enrichment. *Leasepartners Corp. v. Robert L. Brooks Trust*, 113 Nev. 747, 942 P.2d 182 (1997). As such, a subcontractor need not record a lien at all, but may directly pursue the owner of a project when the owner has refused to pay the general contractor for the subcontractor's work *without* a mechanics lien claim. In California, no such cause of action is available. Rather the subcontractor is statutorily limited exclusively to a mechanics lien or stop notice remedy. *Cal.Civ.Code § 3264*. As such, the "public policy" in California restricting the waiver of a contractor's mechanics lien right has no corresponding analogy to Nevada's mechanics lien rights.

This Nevada Supreme Court decision may be correct in the context of the facts to which it applies. Unfortunately, it does not limit itself to those facts. The Court's creation of public policies which are not well thought out will have significant impact on future Nevada construction projects and should be understood by all contracting parties.

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