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JANUARY 2016

Construction Managers and Contractors: Improve Your Mergers & Acquisition and Dissolution Checklists to Avoid Expired License Exposure–and Worse

In Brief

Dissolving a newly acquired or existing affiliate of a construction or construction management firm can have adverse unintended legal consequences when the dissolved affiliate holds executory contracts and the related entity that takes over the performance of the contracts lacks the requisite professional licenses, or any required consents to assignment are not obtained. Both in-house and outside counsel can help clients avoid this risk, the reality of which is underscored by a recent California appellate decision, by expanding dissolution checklists as suggested by this *Commentary*.

The construction industry is continuing to ride a more than decade-long wave of consolidation among contractors, design professionals, and construction management firms. When companies are acquired, it is common for the corporate family to be reorganized for marketing and client service reasons. This often entails consolidation and dissolution of affiliates into an existing or newly formed affiliate. But dissolving a construction firm that holds executory contracts that are to be completed by another member of the corporate family carries with it some significant risks in the event that the affiliate to which the contacts are to be assigned lacks the requisite professional licenses—risks that can be avoided with proper planning.

Under licensing laws of many states, a construction contractor who lacks the requisite professional license at any point during the performance of a contract may not bring an action to recover on a contract, and in California an owner actually may seek disgorgement of all amounts paid even in the absence of actual damages.[1] In the context of dissolving an existing construction affiliate as part of a reorganization, innocent administrative mistakes that happen more often than they should can trigger exposure under licensing laws. The new entity to which the dissolved company's contracts are assigned may lack the proper professional licenses, creating the potential exposure that any unlicensed contractor faces (i.e., inability to

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bring an action to seek payment, the risk of an action by the owner seeking recoupment of all amounts paid under the contract, and/or other civil, administrative, and even criminal consequences).[2] When the original party to the contracts is dissolved, that entity no longer exists and the license of the dissolved entity may have expired,[3] all of which makes reversing the situation problematic. Lastly, the failure to obtain a written consent to assignment and to properly effectuate the assignment may add additional legal exposure, given that many contracts contain restrictions on assignment.

These issues are highlighted in the recent case of *Judicial Council of California v. Jacobs Facilities, Inc.*, 239 Cal. App. 4th 882 (2015), a case that illustrates how California courts continue to take a hard line where the contractor or construction management firm has acted in good faith and a technical licensing violation did not cause any harm or damage to the owner. Fortunately, this type of legal risk can be minimized by expanding the due diligence checklists for dissolution as set forth in this *Commentary*.

Background of the Dispute in *JCC v. Jacobs Facilities*

The Judicial Council of California, Administrative Office of the Courts ("JCC"), entered into a contract with Jacobs Facilities ("Facilities"), a wholly owned subsidiary of Jacobs Engineering Group, Inc. ("JEG").[4] The facilities maintenance and repair agreement required a license under California's Contractors' State License Law ("Licensing Law"),[5] and Facilities was properly licensed when it commenced the work. As part of a subsequent corporate reorganization, parent company JEG dissolved Facilities and initially transferred the employees to JEG and then to another recently formed subsidiary, Jacobs Project Management ("Management"), with these employees continually performing the work under the JCC contract.

JCC later sued JEG and its two subsidiaries and sought return of all moneys paid by JCC under the contract, a total of approximately $18 million.[6] JEG and its subsidiaries defended the claims on the grounds that Facilities, the original party to the contract, was properly licensed, Facilities had assigned the contract to Management prior to expiration of Facilities' license, JCC ratified the assignment when it later consented to Management, and the companies had in all events substantially complied with the licensing requirements.[7] Management also cross-claimed against JCC for approximately $4.7 million in unpaid fees.

The contract between Facilities and JCC was entered in April 2006, and work commenced at that time. In December 2006, JEG undertook a "branding initiative" that included the dissolution of Facilities and the transfer of employees to JEG. While the liquidation of Facilities was effective in December 2006, the corporate entity was not dissolved until September 2010. JEG formed Management in January 2008.

On the licensing side, Facilities had a proper class B license until November 2008 and Management possessed a class B license beginning August 15, 2008. Thus, either Facilities or Management possessed the requisite license at all times while the work was being performed. But a formal assignment was not executed with JCC until December 2009, and Facilities continued to be the signatory on the contract and to invoice the owner until execution of the assignment. This enabled JCC to argue that: (i) Facilities remained the contracting party until execution of the assignment to Management in December 2009, (ii) Facilities did not possess a proper license after its expiration in November 2008, and (iii) therefore work had been performed while the contract was still held by Facilities and *after* its license had expired. JCC filed its disgorgement lawsuit in December 2009, the same month it executed the assignment to Management.

At the conclusion of trial, the jury returned a special verdict for JEG and its subsidiaries finding Facilities had maintained a license at all times while performing the contract and had "internally" assigned the contract to Management on the date Management obtained its license (which was prior to expiration of Facilities' license). Hence, the jury found that all work was performed with a proper license (a determination that hinged on effect of the internal assignment), JCC was not entitled to recoupment of $18 million, and Management was entitled to $4.7 million in unpaid fees. The trial court did not address the issue of substantial compliance, given the jury's finding that a proper license had been maintained throughout performance of the work.

Strict Application of the Licensing Law and Reversal by the *JCC* Appellate Court

Although the jury had found that JCC was not "adversely affected" by the "internal assignment" from Facilities to Management, the Court of Appeal reversed the judgment in favor of the Jacobs entities, holding that Facilities did not strictly comply with the Licensing Law, which was intended to impose "strict and harsh penalties." [8] The Court of Appeal recognized that the Jacobs entities were not "dishonest" or "incompetent" and that the violations asserted by JCC constituted at most "technical transgressions" of the Licensing Law, but dismissed such considerations as "beside the point."[9]

The Court of Appeal found that Facilities' license was allowed to expire *before* JCC accepted a formal assignment to Management, rejecting (i) the effect of the earlier internal assignment between the two subsidiaries, given in part that Facilities continued to be a signatory to the contract, issue invoices, and execute extension of the contract prior to formal execution of the assignment with JCC, and (ii) arguments that contracts are freely assignable among wholly owned subsidiaries of a corporate parent where, as here, the contract contains a nonassignment clause.[10]

Likewise, the Court of Appeal rejected the jury's attempt to reach an "equitable resolution" for violations of the Licensing Law resulting from corporate reorganizations rather than "attempts to evade licensure requirements."[11] The court then applied the full measure of both the shield and the sword provisions of the Licensing Law.

As to the shield aspect of the Licensing Law, Section 7031(a) of the California Business & Professions Code precludes a contractor from bringing an action to recover compensation unless duly licensed *at all times* during the performance of the contract. Accordingly, the Court of Appeal held that Management could not maintain an action to recover fees under the contract.

As to the sword aspect, Section 7031(b) provides that "a person who utilizes the services of an unlicensed contractor may bring an action … to recover *all* compensation paid to the unlicensed contractor for performance of any act or contract." (Emphasis added.) Consequently, the appellate court held that JCC was entitled to recover the $18 million it had paid throughout the several years of performance under the contract prior to the parties executing the assignment. But the Court of Appeal did remand to the trial court for determination of whether the statutory substantial compliance doctrine applied, leaving the Jacobs entities a ray of hope.

Implications for Contractors, Design Professionals and Others

The decision in *JCC* underscores the strictness with which courts apply California's license law even in cases of acknowledged technical violations. This is unlikely to change absent legislative action, as California court decisions repeatedly reiterate that it is up to the Legislature, not the courts, to change this law and how it is applied.[12] Furthermore, this decision highlights the opportunistic actions of some owners who learn of a technical licensing violation where the owner is otherwise fully satisfied with the performance of the contract. In light of the prospect of recoupment of all amounts paid under a contract, public entities—in particular those that face budget challenges and shortfalls—may seize upon technical violations notwithstanding a longstanding and positive relationship with the firm performing the construction services. Not all owners, whether public or private, will behave in this fashion, but providers of construction services need to understand the risks in states with laws like those in California.

The facts and decision in *JCC* send a cold shiver up the spine of principals of construction firms and their counsel, as well as those of traditional engineering and design firms branching into construction management services who may have less familiarity with the nuances of licensing requirements for performing construction services and the consequences of even technical violations. The exposure attendant to momentary lapses in professional licenses for construction services are substantial and can innocently arise through the simple process of corporate reorganizations that result in dissolution of an affiliate.

Jones Day has addressed lapses in licensing after the fact in a number of contexts, including a matter for a *Fortune* 500 company that had dissolved an affiliate holding executory contracts that could not be assigned where the affiliate's license had been allowed to expire. The Firm came up with

a creative solution for this client to successfully resolve this issue without any adverse consequences to the company. But an ounce of prevention is worth a pound of cure when it comes to licensing issues and is why we proactively advise clients to develop checklists to protect against inadvertent mistakes and to adopt procedures to ensure follow up when dissolving affiliates holding construction contracts.

It should also be noted that the potential outcome in the *JCC* case—disgorgement of more than $18 million paid under the contract—could actually be worse in some circumstances because licensing violations may lead to both civil and criminal penalties and actions by licensing boards. Where contracts are with a public entity, an aggressive public entity may try to dress up the licensing violation as a violation of a state's False Claims Act ("FCA") and seek treble damages and civil penalties.[13] Notifying the public entity of the corporate changes may lead to formal approval of the assignment or at least provide grounds for a government knowledge defense to FCA liability should a public agency attempt to assert such a claim.

The best practice for in-house counsel and compliance officers is to use an expanded dissolution checklist that considers the following points in addition to traditional steps that must be followed to effectuate a dissolution (e.g., preparation of dissolution papers, securing requisite corporate approvals, filing with the secretary of state, etc.):

- Does the affiliate to be dissolved hold executory contracts?
- If so, can these contracts be assigned?
- Do those executory contracts require the party performing services to hold certain professional licenses?
- Does the new entity to which the contracts are to be assigned possess the requisite professional license(s)?
- If not, how long will it take to complete the licensing process for this entity?
- When does the license of the party to be dissolved expire, and what steps need to be taken to ensure a license is in place with the entity holding the contract both before the assignment (the affiliate to be dissolved) and after assignment (the affiliate to which the contracts are to be assigned)?
- Has the owner or other contracting party been notified of the assignment in accordance with the terms of the contract?
- Has the owner or other contracting party formally consented or accepted the assignment in accordance with the terms of the contract?
- Has the consent to assignment been executed and returned by the owner or other contracting party (and prior to the effectiveness of the dissolution)?
- If an owner will not consent or accept an assignment, what options does the contract provide, and what other legal steps may be taken?

An expanded checklist is a good start. But follow-up is critical. Too often agreements are dropped in the mail or sent by email, a check mark is made on the checklist, but the requisite follow-up is not assiduously conducted due to the press of other business. Arguments like estoppel must then be made when owners argue that the consent to assignment was not executed and unlicensed work was therefore performed because the license of the to-be-dissolved affiliate was permitted to expire before execution of the assignment.[14]

When an affiliate is being dissolved and its executory contracts requiring a professional license are being transferred, the best protection against a later claim that unlicensed work was performed is to ensure the agreement (whether a consent to assignment, a novation, or some other form of agreement) has been executed by the owner and returned to the contractor before the dissolution is effective. Indeed, there is no reason why such an agreement cannot be placed at the front end of the dissolution process to ensure maximum protection (i.e., the consent to transfer being executed before the dissolution and after confirmation that the affiliate to which the contract is to be assigned holds the requisite professional licenses).

Conclusion

The *JCC* decision highlights the potentially severe consequences that may result from dissolution of a licensed affiliate and assignment of executory contracts following a merger or corporate reorganization. Jones Day has advised construction and engineering firms on these types of issues

and on due diligence checklists in connection with mergers and acquisitions to minimize the risks of innocent errors or oversights that may lead to claims that license laws have been violated. Following the suggestions in this *Commentary* will help protect against such unpleasant surprises.

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Endnotes

1 *See* Cal. Bus. & Prof. Code § 7031(a)-(b); *see also* Ark. Code Ann. § 17-25-103(d); Ariz. Rev. Stat. § 32-1153; Fla. Stat. § 489.128(1); Or. Rev. Stat. Ann. § 701.131(1)(a); N.M. Stat. Ann. § 60-13-30(A); N.Y. C.P.L.R. 3015(e); *Crowe v. Hickman's Egg Ranch, Inc.*, 41 P.3d 651, 655 (Ariz. Ct. App. 2002); *B & F Bldg. Corp. v. Liebig*, 564 N.E.2d 650, 651-52 (N.Y. 1990).

2 *See, e.g.,* Cal. Bus. & Prof. Code § 7028 (misdemeanor to act as contractor without a license); *id.* § 7028.7 (citations and civil penalties for unlicensed activities); Cal. Code of Regs. § 860 (Contractors State Licensing Board may impose penalties and take disciplinary action for failure to comply with rules and regulations).

3 *See, e.g.*, Cal. Bus. & Prof. Code § 7076(h) (corporation license cancelled upon "dissolution, merger, or surrender of its right to do business in the state").

4 *JCC*, 239 Cal. App. 4th at 890.

5 Cal. Bus. & Prof. Code §§ 7000 *et seq*.

6 *JCC*, 239 Cal. App. 4th at 889. The Licensing Law permits a person "who utilizes the services of an unlicensed contractor" to bring an action for disgorgement of "all compensation paid to the unlicensed contractor." Cal. Bus. & Prof. Code § 7031(b). This includes all compensation under the contract and not just compensation for the period when the contractor was unlicensed. *Alatriste v. Cesar's Exterior Designs, Inc.*, 183 Cal. App. 4th 656, 666 (2010).

7 The Licensing Law contains an exception to disgorgement if the court determines that the elements of statutory substantial compliance have been met, including that the contractor: "(1) had been duly licensed as a contractor in this state prior to the performance of the act or contract, (2) acted reasonably and in good faith to maintain proper licensure, (3) did not know or reasonably should not have known that he or she was not duly licensed when performance of the act or contract commenced, and (4) acted promptly and in good faith to reinstate his or her license upon learning it was invalid." Cal. Bus. & Prof. Code § 7031(e). Courts in California may not apply judge made substantial compliance doctrine, only the statutory substantial compliance exception. *JCC*, 239 Cal. App. 4th at 896.

8 *JCC*, 239 Cal. App. 4th at 900.

9 *Id.*

10 *Id.* at 905.

11 *Id.* at 911-12.

12 *Id.* at 901.

13 *See, e.g.*, Cal. Gov't Code §§ 12650-12656 (false claims act).

14 *See JCC*, 239 Cal. App. 4th at 892 (owner did not respond for almost a year to a novation agreement that had been mentioned by contractor and sent to owner).

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