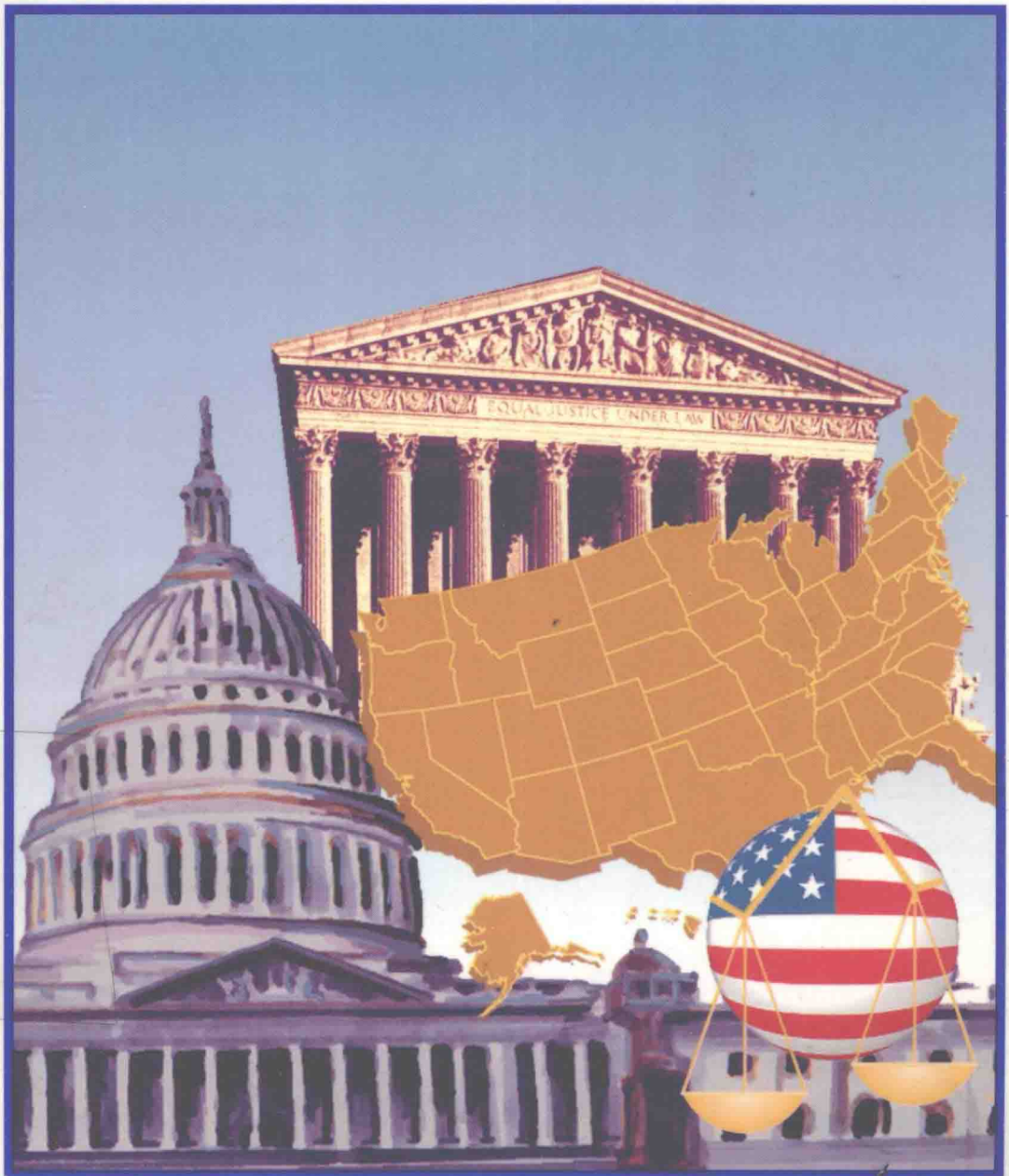


CUTTING EDGE CASES IN THE LEGAL ENVIRONMENT OF BUSINESS

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Preface

CUTTING EDGE CASES fills the need for an up-to-the-minute collection of edited cases, using the court's own language, for business law and the legal environment of business. Technological advances make it possible for this book to include cases decided as recently as June 29, 1992, yet be available for the academic year beginning Fall 1992.

This book is designed for several constituencies. On one level, it updates the often dramatic changes that have taken place in the law over the past two years. At the same time, it provides an opportunity for business students and law students to explore cases in the court's own language in an expanded format. For other readers, the book provides a snapshot of judicial activity these past two years.

The cases presented here were selected for timeliness, impact, coherence, and diversity. While most of them were handed down by the United States Supreme Court, all levels of judicial review, including state as well as federal appellate courts, are represented.

A few of the cases selected may, at first blush, appear to have only a tenuous connection to the legal environment of business. However, each case demonstrates the current approach of the courts to key areas. For example, the 1991 United States Supreme Court case of *Florida v. Bostick* addresses the constitutionality of "bus sweeps," a popular interstate drug interdiction tactic. The holding of the case illustrates the Court's recent liberalization of the restrictions on Fourth Amendment search and seizure. *Planned Parenthood v. Casey*, a 1992 case in which the Supreme Court declined to overrule entirely the 1973 abortion case *Roe v. Wade*, shows both the power of precedent and *stare decisis* as principles of common law jurisprudence, and the Court's most current articulation of substantive due process under the Constitution. In short, cases dealing strictly with business law are not the only cases that affect the legal environment of business.

The cases have been cross-listed in a table to quickly identify relevant topics in business law and the legal environment of business to which the cases relate. This makes it possible for professors to use this book in conjunction with any text in this area, including, but not limited to, the author's **MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY** (West Publishing Co., 1991). Some cases are listed under more than one topic. This assignment is

a recognition that some cases impact more than one area of law. For example, *Cipollone v. Liggett* opens the door for cases in tort against the tobacco manufacturers for conditions such as emphysema and cancer suffered by smokers. However, because the case was decided on a narrow pre-emption issue that examines the intersections of state and federal laws, it is listed under "Courts and Jurisprudence" as well as "Products Liability."

The past two years have witnessed a great deal of change in the law. With the appointment of Justices Souter and Thomas to the United States Supreme Court, new alliances have formed on the Court and the political nature of law has become more apparent. To appreciate the shift, notice the tone of Justice Marshall's dissent in *Florida v. Bostick* and Justice Stevens's dissent in *Nordlinger v. Hahn*. Read what Justice Blackmun has to say about abortion in *Planned Parenthood v. Casey* and then what Justice Scalia says about Justice Blackmun in the same case. These often scathing attacks reflect a level of politicization in the judiciary that will affect decisions for years to come.

The expanded treatment of the cases here allows students to explore the nature of decisions more thoroughly, scrutinizing the reasoning and considering a competing argument presented by the dissent. The dissents in *Mexicali Rose*, or even *Rust v. Sullivan*, for example, may be more persuasive to the reader. And while it is tempting to discount the importance of a dissenting opinion, remember that as court composition changes, the reasoning of today's dissent may carry tomorrow's majority.

The cases are presented as follows: First, introductory history and facts of the case are summarized and presented in the **Background** section. Then, the disposition of the case is summarized under the heading **Held**. Under **Opinion**, the cases are presented in the court's own language, edited only for size constraints. Ellipses are used to indicate that a portion of the court's language -- other than citations and footnotes -- has been omitted. A set of indented ellipses indicates the omission of one or more paragraphs. In addition, most citations and footnotes have been omitted.

C.E.B.
C.A.H.

**Cross-Reference Guide
for**

CUTTING EDGE CASES

**by Topics in
Business Law and the Legal Environment of Business**

Ethics and the Law

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COHEN v. COWLES MEDIA COMPANY
MASSON v. NEW YORKER MAGAZINE, INC.
BASIC BOOKS, INC. v. KINKO'S GRAPHICS CORPORATION
UNITED STATES OF AMERICA v. ROBERT CHESTMAN

Constitutional Bases for Business Regulation

PLANNED PARENTHOOD OF S.E. PENNSYLVANIA v. CASEY
SIMON & SCHUSTER v. NEW YORK CRIME VICTIMS BOARD
CHEMICAL WASTE MANAGEMENT, INC. v. HUNT
NORDLINGER v. HAHN
INTERNATIONAL UNION, UAW v. JOHNSON CONTROLS
LUCAS v. SOUTH CAROLINA COASTAL COUNCIL

Courts and Jurisprudence

PLANNED PARENTHOOD OF S.E. PENNSYLVANIA v. CASEY
CIPOLLONE v. LIGGETT GROUP, INC.

Administrative Law

RUST v. SULLIVAN
LECHMERE, INC. v. NLRB

Criminal Law

FLORIDA v. BOSTICK
UNITED STATES OF AMERICA v. CHESTMAN

Torts

MASSON v. NEW YORKER MAGAZINE, INC
MEXICALI ROSE v. THE SUPERIOR COURT OF ALAMEDA
COUNTY
CIPOLLONE v. LIGGETT GROUP, INC.

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HYDROTECH SYSTEMS, LTD. v. OASIS WATERPARK
COHEN v. COWLES MEDIA COMPANY

Sales

MEXICALI ROSE v. THE SUPERIOR COURT OF ALAMEDA
COUNTY

Products Liability

MEXICALI ROSE v. THE SUPERIOR COURT OF ALAMEDA
COUNTY
CIPOLLONE v. LIGGETT GROUP, INC.

Environmental Law

CHEMICAL WASTE MANAGEMENT, INC. v. HUNT

Land Use Control and Real Property

LUCAS v. SOUTH CAROLINA COASTAL COUNCIL
NORDLINGER v. HAHN

Copyrights and Intellectual Property

BASIC BOOKS, INC. v. KINKO'S GRAPHICS CORPORATION

Employees and Labor Relations Law

INTERNATIONAL UNION, UAW v. JOHNSON CONTROLS
LECHMERE, INC. v. NLRB

Securities Regulation and Takeovers

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Creditor-Debtor Relations and Business Bankruptcies

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HYDROTECH SYSTEMS, LTD. v. OASIS WATERPARK

SUPREME COURT OF CALIFORNIA

52 Cal. 3d 988; 803 P.2d 370

Decided January 24, 1991

"However artful the pleadings, if the primary fraud alleged is a false promise to pay for unlicensed construction work, and the primary relief sought is compensation for the work, section 7031 bars the action. "

Background: Hydrotech, Inc. is a New York corporation that manufactures and installs equipment that creates ocean-like "waves" in pools. They are not licensed to do this work in California. Oasis Waterpark is a water-oriented amusement park located in Palm Springs, California. Desiring the unique patented device and installation of Hydrotech's wave-creating equipment, Oasis's contractor, Wessman, contracted with Hydrotech to sell and install the equipment at the Oasis Waterpark for a total contract price of \$850,000. The contract provided that Wessman was to hold a specified portion of the price pending satisfactory operation of the pool.

Wessman withheld the price for the equipment once the pool was fully operative. Hydrotech sued for the price of the equipment. Hydrotech also made a fraud claim against Oasis, asserting that they had originally hoped to only sell and deliver equipment for the wave pool, not install it, due to licensing concerns. Hydrotech further alleged that Oasis, in order to persuade Hydrotech to install the equipment, promised that they would arrange for a California-licensed contractor to "work with" Hydrotech on any construction. Hydrotech asserted that had they known that Oasis's promises were false when

made, they would not have relied to their detriment in performing the work.

Section 7031 of the Business and Professions Code states that one may not sue in a California court to recover "compensation" for "any act or contract" that requires a California contractor's license, unless one "alleges and proves" he was duly licensed at all times during the performance. Hydrotech argued that section 7031 should not be applied because they possess unique expertise in the field and performed only at the customer insistence. In addition, they asserted that section 7031 does not apply to the sale of equipment, only services, and does not bar tort actions for fraud.

The Court of Appeal reversed the trial court's finding that the fraud claim should be dismissed, but affirmed the dismissal of all other claims.

Held: Section 7031 bars Hydrotech's cause of action for fraud.

Opinion: by EAGLESON, J.

We granted review to decide two questions. The first is whether section 7031 permits an unlicensed nonresident to sue upon an "isolated transaction" in California where "exceptional circumstances" exist, even though there was no substantial compliance with California's licensing law. The second -- an issue of potentially broad importance -- is whether section 7031 bars an unlicensed contractor's fraud action against the person for whom the work was done.

We conclude, as did the Court of Appeal, that section 7031 contains no implied exception for foreign entities, isolated transactions, or other "exceptional" circumstances. We also hold, contrary to the Court of Appeal, that the statute bars an unlicensed contractor's claim for fraud when the primary deceit alleged is a false promise to pay, and the damages primarily consist of, or are measured by, the price or value of the work and materials furnished. Any other result would circumvent the clear statutory policy of deterring unlicensed contract work. We therefore affirm in part and reverse in part the decision of the Court of Appeal.

Discussion

1. Section 7031 applies despite the "exceptional circumstances" of this transaction.

Hydrotech renews its contention that the "exceptional circumstances" of its dealings with Oasis make application of section 7031 unnecessary and unjust. Hydrotech points to its allegations that it reluctantly provided construction services on a one-time basis only

because Oasis solicited its specialized wave-generation expertise, which was available nowhere else. Hydrotech argues that the "isolated" provision of such specialized services by a mere subcontractor should be deemed exempt from section 7031. The law, however, is otherwise.

Section 7031 states clearly that, with exceptions not relevant here, "[n]o person engaged in the business or acting in the capacity of a contractor, may bring or maintain any action" in a California court to recover "compensation for the performance of any act or contract for which a [contractor's] license is required . . . without alleging and proving" that he or she "was a duly licensed contractor at all times during the performance of [the] act or contract"

Section 7026 provides that, for purposes of the license requirements, "a contractor is any person, who undertakes to or offers to undertake to . . . , or does himself or by or through others, construct . . . any . . . structure, project, development or improvement, or to do any part thereof, . . . whether or not the performance of [such] work . . . involves the addition to or fabrication into any [such] structure, project, development or improvement . . . of any material or article of merchandise. The term contractor includes subcontractor and specialty contractor." The numerous express exemptions from the licensing law (§ 7040 et seq.) do not include foreign contractors, isolated transactions, or "unique" building services and capabilities.

The purpose of the licensing law is to protect the public from incompetence and dishonesty in those who provide building and construction services (citation omitted). 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 (citation omitted).

Section 7031 advances this purpose by withholding judicial aid from those who seek compensation for unlicensed contract work. The obvious statutory intent is to discourage persons who have failed to comply with the licensing law from offering or providing their unlicensed services for pay.

Because of the strength and clarity of this policy, it is well settled that section 7031 applies despite injustice to the unlicensed contractor. . . .

Hydrotech concedes that it had no California license, yet seeks contract compensation for activities which required such a license. It simply urges that California courts have recognized "exceptional

circumstances" in which literal application of section 7031 would not further the purposes of the licensing law.

However, the authorities Hydrotech cites all relate to the well-established doctrine of substantial compliance. Under this rule, a contractor was not barred from a just recovery if his licensure was defective only in form and the defendant had received the "full measure" of protection intended by the Legislature (citations omitted).

Such is not the case here. The protective purposes of the licensing law cannot be satisfied in full measure unless the "continuing competence and responsibility" of those engaged in the work for which compensation is sought have been officially examined and favorably resolved (citation omitted). Hydrotech does not state that it ever sought or obtained any such favorable official determination of its qualifications, or those of its agents involved in the pool construction. There is no basis for an inference that the law's full protective purposes were served despite the entire absence of necessary licensure. Hence, Hydrotech has not alleged its "substantial" compliance with the licensing law.

Hydrotech claims the law's interests in competence and public protection were not disserved in this case because its agreement to design and construct the surfing pool for Oasis was an "isolated" California transaction. However, as the Court of Appeal observed, "It is manifest that the concern for the public inherent in section 7031 is just as applicable to a project done by an out-of-state contractor with few jobs in California as to a project done by a California contractor who performs only one job in California before going out of business." That Hydrotech's activities in California were "isolated" is not clear from the pleadings, but even if they were, there is no implied exception for "isolated" transactions by foreign contractors (citation omitted).

.

Finally, we dismiss Hydrotech's claim that the law's protective purpose was served because Hydrotech acted only as a subcontractor and did not hold itself out to the public. Subcontractors are governed as such by the licensing law Both owners and general contractors are entitled to protection against illegal subcontract work by unlicensed persons. Hence, an unlicensed subcontractor may not recover compensation for his work from either the owner or the general contractor (citations omitted).

We therefore conclude, as did the Court of Appeal, that Hydrotech has alleged no "exceptional circumstances" which would exempt it from the operation of section 7031.

2. Section 7031 bars Hydrotech's fraud claim.

The Court of Appeal accepted Hydrotech's alternative claim that even if section 7031 eliminates contractual and quasi-contractual claims seeking "compensation" for unlicensed work, it does not bar Hydrotech's recovery of tort damages arising from defendants' fraud which induced Hydrotech to contract and perform. Defendants assert that the Court of Appeal thus erred. We agree.

Regardless of the equities, section 7031 bars all actions, however they are characterized, which effectively seek "compensation" for illegal unlicensed contract work (citation omitted). Thus, an unlicensed contractor cannot recover either for the agreed contract price or for the reasonable value of labor and materials (citation omitted). The statutory prohibition operates even where the person for whom the work was performed knew the contractor was unlicensed (citation omitted).

It follows that an unlicensed contractor may not circumvent the clear provisions and purposes of section 7031 simply by alleging that when the illegal contract was made, the other party had no intention of performing. Section 7031 places the risk of such bad faith squarely on the unlicensed contractor's shoulders. . . .

Hydrotech alleges that it was induced to enter and perform an illegal contract by a false promise to pay; that it would not have performed had it known the promise was false when made; and that it therefore suffered damage "according to proof." The complaint states no facts suggesting that the "damage" to be proven and recovered is anything other than that asserted elsewhere in the complaint -- i.e., the unpaid contract balance or its *quantum meruit* equivalent.

In sum, Hydrotech proposes that defendants' unenforceable promise to pay for illegal work is actionable because defendants made the promise in bad faith. Such transparent pleading cannot be used to avoid section 7031.

The Court of Appeal concluded that disallowance of fraud claims like Hydrotech's would contravene the protective policies of the licensing law by encouraging professional contractors such as Wessman to seek out unlicensed subcontractors, secure in the knowledge that the work obtained would not have to be compensated. Justice Broussard expresses similar concerns that such a result would encourage the cheating of unlicensed contractors (citation omitted). We are not persuaded, however. A general contractor may be disciplined for subcontracting with knowledge that the subcontractor is unlicensed Moreover, the unusual circumstances of this case aside, it is unlikely that a rational general contractor would

intentionally risk liability for claims that the subcontractor's unlicensed subcontractor had performed substandard work.

In any event, the statutory disallowance of claims for payment by unlicensed subcontractors is intended to deter such persons from offering their services, or accepting solicitations of their work. That policy applies regardless of whether the other party's promise to pay for the work was honest or deceitful.

. . . .

Nonetheless, we stop short of disapproving *Grant*, *Brunzell*, and *Pickens*¹ insofar as they might apply to this case. The Legislature amended section 7031 several times between 1954, the year *Grant* was decided, and 1986, the year Hydrotech apparently finished its unlicensed work for Oasis. During that time, however, the Legislature expressed no disagreement with this line of decisions. The legislature's inaction is some indication that it accepted existing judicial limitation on section 7031 (citations omitted).

We conclude, however, that *Grant* and its progeny are properly interpreted in the context of their particular facts. In each case, the plaintiff's involvement as an unlicensed contractor was incidental to the overall agreement or transaction between the parties. By the same token, the primary fraud alleged in each case was external to the arrangement for construction work as such, and was thus unrelated to any protective concern of the licensing law. Under these extraordinary circumstances, the Courts of Appeal understandably concluded that the peripheral involvement of unlicensed contract work did not shield defendants from all tort liability.

No California case has squarely held that an unlicensed contractor may transform a barred claim into a permissible one simply by alleging that the unenforceable promises of payment which induced him to perform were false when made. For reasons already stated, we decline to extend *Grant's* reasoning to the situation presented here. In a garden-variety dispute over money owed an unlicensed contractor, the contractor cannot evade section 7031 by alleging that the express or implied promise to pay for the contractor's work was fraudulent. However artful the pleadings, if the primary fraud alleged is a false promise to pay for unlicensed construction work, and the primary relief sought is compensation for the work, section 7031 bars the action.

¹ These are three cases that feature contractors who were allowed to recover damages in tort despite their unlicensed status. -- Ed.

The judgment of the Court of Appeal is reversed insofar as it upholds Hydrotech's cause of action for fraud, and affirmed in all other respects.

Dissent: BROUSSARD, J., Concurring and Dissenting.

I agree with the majority insofar as they hold that Business and Professions Code section 7031 (hereafter section 7031) bars plaintiff's actions for breach of contract, breach of implied contract, and money due and owing.

However, I must dissent from the determination that the fraud cause of action is also barred. The language of section 7031 has been repeatedly construed by the Courts of Appeal to permit actions for fraud, and the Legislature, despite amending the code section in other respects, has not changed the crucial language. Under the reenactment rule this should end the case. In any event, sound policy requires that the section should not be construed to bar any fraud claims. The majority's holding, barring some fraud claims but not others, not only rewards fraudulent wrongdoers, but defeats the protective policies of the code section by encouraging intentional wrongdoers to seek out and hire unlicensed contractors, secure in the knowledge that the work need not be compensated.

The complaint clearly alleges a fraudulent scheme whereby defendants with the intent of avoiding payment under their contract insisted that Hydrotech Systems, Inc. (Hydrotech), known to be unlicensed, engage in contracting work for which a license was required. This is not a case where Hydrotech solicited work in California. Hydrotech did not hold itself out as licensed to contract for the design and construction of the pool. Indeed, Hydrotech refused to engage in contracting work. Hydrotech sought only to sell wave-making equipment and sought to avoid involvement in design or construction. . . .

. . . .

Until today, it was settled that section 7031 did not preclude actions for fraud (citations omitted). . . .

. . . .

The reasoning is unanswerable. The majority characterize the reasoning of *Pickens*, *Brunzell Constr. Co.* and *Grant* as "dicta" (citations omitted), but this is the basic reasoning of the cases.

The reenactment rule requires us to follow these cases. "Where a statute has been construed by judicial decision, and that construction is not altered by subsequent legislation, it must be presumed that the

Legislature is aware of the judicial construction and approves of it" (citations omitted). Section 7031 has been repeatedly amended since the 1954 decision in *Grant v. Weatherholt* (citations omitted) and it has never provided that fraudulent wrongdoers may take advantage of the section or that denial of access to the courts in cases of fraud is one of the penalties imposed for violation of the licensing law.

The majority pay lip service to this rule. In recognition, they say we should not disapprove *Grant*, *Brunzell*, and *Pickens*. But then they state each should be limited to its facts (citation omitted). The reenactment rule has always been that the judicial "construction" of a statute has been approved, not merely its application to specific facts.

Even if the reenactment rule were not controlling, the reasoning of the cases is compelling.

Moreover, sound policy requires that we do not go beyond the legislative determination that contract and implied contracts are barred by section 7031. . . . To further the purpose of deterring unlicensed contractors, the Legislature has provided that the unlicensed contractor may not recover in a contract action or implied contract action. It has never provided that fraudulent wrongdoers may be rewarded under the statute or that unlicensed people may not recover for fraud.

This court should not go beyond the penalties and forfeitures established by the Legislature and establish additional ones on its own. The Legislature has not abolished tort remedies such as fraud, and we should not enrich those who rely upon section 7031 in the perpetration of a fraud or in the consummation of a fraudulent scheme (citations omitted).

As the Court of Appeal pointed out in the instant case, the purpose of section 7031 is frustrated by holding that fraudulent wrongdoers may escape their debts by asserting the bar of section 7031. As stated above, the purpose of section 7031 is to deter unlicensed persons from engaging in contracting. Allowing fraudulent wrongdoers to obtain the substantial penalties and forfeitures and be unjustly enriched can only encourage owners and contractors to engage in fraudulent schemes to hire unlicensed persons in anticipation that, when the debts come due, they can turn their backs and refuse to pay in reliance on section 7031. As in the instant case, California contractors and owners will be encouraged to seek out and employ unlicensed out-of-state contractors in the hope of obtaining services without paying for them. We should not encourage such wrongdoing. On the other hand, the legislative policy of deterrence is not furthered by denying recovery for fraud. Unlicensed contractors are not encouraged to undertake the unlawful activity by the remote possibility that, if unpaid, they might be able to prove fraud.