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SUPERIOR COURT OF THE STATE OF CALIFORNIA

FOR THE COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER AUTHORITY, Petitioner and Plaintiff, vs. METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA; ALL PERSONS INTERESTED IN THE VALIDITY OF THE RATES ADOPTED BY THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA ON APRIL 10, 2012 TO BE EFFECTIVE JANUARY 1, 2013 AND JANUARY 1, 2014; and DOES 1-10, Respondents and Defendants.	Case No. CPF-10-510830 Case No. CPF-12-512466 **RESPONDENT AND DEFENDANT METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA'S MEMORANDUM OF LAW RE MEASURE OF DAMAGES** Hon. Curtis E.A. Karnow Dept.: 304 Hearing Date: November 3, 2014 Hearing Time: 2:00 p.m. Actions Filed: June 11, 2010; June 8, 2012

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Preliminary Statement

By statute, two measures of contract damages exist in California: compensatory (*i.e.*, putting the plaintiff in the same position as if the promise had been performed) and liquidated (*i.e.*, fixing an amount by agreement). Section 12.4(c) of the Exchange Agreement is neither. It is not compensatory because it grants Petitioner San Diego County Water Authority ("SDCWA") the unilateral right to demand that Respondent Metropolitan Water District of Southern California ("MWD") set aside any amount, however large, mistaken or disputed, which puts SDCWA in a better position than if the contract had been performed as SDCWA contends. It is not liquidated because, among other reasons, there is no fixed or agreed amount. Accordingly, §12.4(c) is not a measure of damage recognized under California law.[1]

Section 12.4(c) is a security provision. It is a practical solution to a problem of enforcing monetary judgments against government agencies. A government agency may not have cash to pay an adverse judgment. This clause protects both MWD and SDCWA. SDCWA has to continue paying the amount charged; if it stopped paying, MWD might not be able to recover the arrearage if it prevails. Similarly, if MWD did not set aside the alleged overpayment, SDCWA might not recoup the overage if it prevails. Section 12.4(c) assures both parties that, at the end of litigation, an amount will be retained or returned promptly so that SDCWA will have paid and MWD will have received what each was entitled to under the contract.

The language of the contract, the parties' intent, the testimony of both parties' "persons most knowledgeable," and even SDCWA's pleadings and positions in this litigation, confirm that the proper measure of damages here is general compensatory damages under the Civil Code, not §12.4(c).

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[1] Section 12.4(c) provides: "In the event of a dispute over the Price, SDCWA shall pay when due the full amount claimed by Metropolitan; provided, however, that, during the pendency of the dispute, Metropolitan shall deposit the difference between the Price asserted by SDCWA and the Price claimed by Metropolitan in a separate interest bearing account. If SDCWA prevails in the dispute, Metropolitan shall forthwith pay the disputed amount, plus all interest earned thereon, to SDCWA. If Metropolitan prevails in the dispute, Metropolitan may then transfer the disputed amount, plus all interest earned thereon, into any other fund or account of Metropolitan." Exchange Agreement, attached to Borden Decl. as Ex. A, §12.4(c)

Argument

I. THE CIVIL CODE LIMITS THE MEASURE OF DAMAGES TO COMPENSATORY AND LIQUIDATED DAMAGES

SDCWA seems to suggest that §12.4(c) creates a third measure of damages: one that is different from either compensatory damages or a valid liquidated damages clause. By statute, there is no such third measure.

Civil Code §§3300, *et seq.* govern the measure of damages for breach of contract in California. *See Erlich v. Menezes*, 21 Cal. 4th 543, 550 (1999); *Amato v. Mercury Cas. Co.*, 53 Cal. App. 4th 825, 831 (1997). Pursuant to Civil Code §3300, contract damages are compensatory unless another provision in the Civil Code "*expressly*" provides for a different measure:

> For the breach of an obligation arising from contract, the measure of damages, except where otherwise *expressly* provided by this code, is the amount which will *compensate* the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.

(emphasis added). Similarly, Civil Code §3358 provides that, other than "as expressly provided by statute, no person can recover a greater amount in damages for the breach of an obligation, than he could have gained by the full performance thereof on both sides."

The Civil Code is consistent with long established principles of contract law. An award of contract damages should "place the injured party in the same position it would have held had the contract properly been performed, *but such damages may not exceed the benefit which it would have received had the promisor performed*." *Brandon & Tibbs v. George Kevorkian Accountancy Corp.,* 226 Cal. App. 3d 442, 468 (1990) (emphasis added); *see also Lewis Jorge Constr. Mgmt., Inc. v. Pomona Unified Sch. Dist.,* 34 Cal. 4th 960, 968 (2004) (damages cannot exceed what the injured party would have received if the contract had been fully performed).

Here, the only statute SDCWA has cited to support its argument that §12.4(c) is the measure of damages is Civil Code §1671 governing liquidated damages. *See* Joint CMC Statement for July 2, 2014 Case Management Conference at 5:4-5 and 6:2-4; SDCWA's

Consolidated Opposition to MWD's Motion for Leave to Amend Answers and Motion to Reopen Expert Discovery dated July 24, 2014 at 10:20-21 and 11:19-22, attached to Borden Decl. as Exs. B and C. But, as shown below, §12.4(c) is not a liquidated damages clause and would not be enforceable even if it were. *See* § IV, *infra*.

Seemingly recognizing the point, SDCWA has argued that §12.4(c) is "akin" to a liquidated damages clause, *i.e.*, it is a measure of damages that is neither compensatory nor liquidated. But the Civil Code does not recognize a third measure, one that is not liquidated damages but is "akin" to such. Either §12.4(c) is a liquidated damages clause -- because it meets all the legal requirements -- or it is not, in which case it runs afoul of Civil Code §3300. If SDCWA contends that §12.4(c) is a liquidated damages clause, it must show that it satisfies the requirements. If §12.4(c) is not a liquidated damages clause, it must prove compensatory damages under the general measure provided by Civil Code §3300. *See Perdue v. Crocker Nat'l Bank*, 38 Cal. 3d 913, 931 n.16 (1985), *citing Garrett v. Coast So. Fed. Sav. & Loan Assn.*, 9 Cal. 3d 731, 738 (1973) (where party seeks liquidated damages pursuant to contract, it must "meet[] the requirements of section 1671").

II. SDCWA HAS TACITLY CONCEDED THAT SECTION 12.4(C) IS NOT THE MEASURE OF DAMAGES

A. SDCWA Has Never Pleaded Section 12.4(c) as the Measure of Damages; Instead, It Pleaded Compensatory Damages.

SDCWA's pleadings and positions in this litigation contradict SDCWA's new damages theory. A tell-tale sign that SDCWA itself did not believe §12.4(c) was a damages clause is that it never pleaded such damages; instead, it alleged general compensatory damages "according to proof." *See* First, Second and Third Amended Petitions and Complaints in the 2010 Action; Petition and Complaint in the 2012 Action; and Petition and Complaint in the 2014 Action; attached to Borden Decl. as Exs. D-H.

Thus, in its Third Amended Petition and Complaint in the 2010 Action, filed in 2013, SDCWA alleged: "Metropolitan's unlawful misallocation of costs has caused Water Authority to

pay excess charges for its transportation of Non-Metropolitan Water, *in an amount to be determined according to proof*." TAC at 34, ¶ 102, attached to Borden Decl. as Ex. F (emphasis added). In its prayer for relief, it requested: "As to the Fourth Cause of Action [for breach of contract], an award of *compensatory and general damages* against Metropolitan in an *amount to be determined according to proof* . . . ." *Id.* at 39, ¶ 4 (emphasis added).[2] *See also* Petition and Complaint in 2012 Action at 34, ¶ 4, and Petition and Complaint in 2014 Action at 27, ¶ 4, attached to Borden Decl. as Exs. G and H.

A party seeking liquidated damages must plead liquidated damages and the basis therefor. *See Purcell v. Schweitzer*, 224 Cal. App. 4th 969, 975 (2014) ("a litigant seeking the benefits of a clause purporting to fix liquidated damages must plead and prove that the clause is valid under the facts which then existed"); *Ruwe v. Cellco P'ship*, 613 F. Supp. 2d 1191, 1196 (N.D. Cal. 2009) (same). Here, SDCWA not only failed to plead liquidated damages in any of the complaints in which it asserts breach of contract, *it pleaded the opposite*: It alleged general compensatory damages to be proved at trial.

SDCWA also repeatedly represented to the Court that it seeks compensatory damages and needed discovery to calculate and prove the specific amount at trial. In moving to compel, SDCWA represented that obtaining information about MWD's costs is "*critical for calculating SDCWA's damages* pursuant to its breach of contract claim." SDCWA Memo. in Support of Motion to Compel at 9:27-28, attached to Borden Decl. as Ex. I (emphasis added). In another brief, it argued that "SDCWA's ability to calculate damages precisely is hampered by MWD's refusal to produce its 'rate model' and other documents in MWD's exclusive possession that are necessary to calculate the amount of MWD's overcharges. . . . *Once MWD has produced that discovery, SDCWA will be better able to calculate its damages and to identify the documents it*

[2] The only reference to §12.4(c) in the prayer for relief is SDCWA's request that it be awarded *interest* "both as a matter of general damages principles and as a result of the express term in section 12.4(c) of the [Exchange] Agreement, which requires MWD, in the event of a rate challenge, to place all disputed amounts in an interest-bearing escrow account." TAC at p. 39, ¶ 4, attached to Borden Decl. as Ex. F.

will rely on to prove a damages amount." SDCWA Memo. in Opp. to MWD's Motion to Compel at 14:23-27, attached to Borden Decl. as Ex. J (emphasis added).[3]

As the foregoing examples demonstrate, SDCWA has asserted repeatedly that the measure of damages is compensatory. At the same time, SDCWA has demanded that certain amounts be set aside. SDCWA's conduct would make no sense if §12.4(c) were, as SDCWA now asserts, the measure of damages. SDCWA's years' long conduct does, however, make sense for a party that always understood that the measure of damages would not be the amount it claimed was disputed, but the amount that would compensate it for the detriment caused by the alleged breach of contract.

B. The Amount Put in Dispute by SDCWA Under Section 12.4(c) Did Not Measure Actual Damages.

That the amount disputed by SDCWA under §12.4(c) is not, and was not even an attempt to be, a measure of damages is confirmed by SDCWA's own expert. SDCWA placed in dispute, and required MWD to set aside, $236 per acre foot, which is its calculation of overcharges for system power ($94), water stewardship ($41) and system access ($101). However, SDCWA's employee and damages expert, Daniel Denham, testified that this amount is *not* a measure of damages.

First, Mr. Denham acknowledged that lowering the price of conveyance charges would increase the price of "full service" water that SDCWA purchased. Denham Depo. at 31:1-9, 69:6-71:8, 88:13-90:18, attached to Borden Decl. as Ex. L.[4] He admitted that the offset was not factored into the disputed amount: Q: "Did you also calculate how much more [SDCWA] would have to pay under one or more supply rates if this reallocation occurred?" A: "I did not." *Id.* at

[3] SDCWA further argued: "[W]e also have a breach of contract claim which has a damages component, and part of that is going to *require us to calculate the overcharge . . . .*" April 23, 2013 Hearing Transcript at 32:10-22, attached to Borden Decl. as Ex. K (emphasis added).

[4] SDCWA's "person most knowledgeable" concerning damages similarly testified that if MWD allocated to supply certain of the costs that it currently allocates to conveyance, SDCWA would have to pay more for water supply. Cushman Depo. at 425:7-25, attached to Borden Decl. as Ex. M.

148:18-21. Q: "To what extent does your analysis take into account that San Diego's supply rate will go up?" A: "It does not take that into account." *Id*. at 91:2-5. Therefore, paying SDCWA the amount set aside under §12.4(c) would put it in a better position than if the contract had been performed as SDCWA contends it should have been.

Second, Mr. Denham agreed that his calculation of "misallocated rates" was not a calculation of damages (*i.e.*, the difference between the amount SDCWA paid and the amount it would have paid in the absence of any alleged breach): Q: "As part of your damages analysis, you didn't make any effort to come up with a scenario about how much San Diego would have paid had there been no breach of contract, did you?" A: "That was not part of my scope." *Id.* at 94:15-21.

Third, Mr. Denham acknowledged that reconstituting the conveyance rate could lead to other changes:

> Q: If all of this had been moved over to supply, all of these charges we talked about, other elements of the rates could have changed, right?
>
> A: Well, certainly, if you take a revenue requirement off of the transportation rate and move it somewhere, the transportation rate is lowered. Where you move it and the net effect of that on your overall -- the money you're spending as an agency, as San Diego, there's certainly an opportunity for a difference in what you spend now and what you spend in the future in some sort of rate structure that has been changed.

Id. at 98:1-12. Even though SDCWA recognized that MWD would change its rate structure, its calculation of the disputed amount did not take that fact into account: Q: "And you have not done anything to quantify the possibility in any way that [MWD] might change their rate structure in response to that cost allocation that you're talking about?" A: "I have made no assumptions for this report as to a modified rate structure." *Id.* at 164:20-165:1. Indeed, Mr. Denham repeatedly said in his deposition that "I am not a rate expert." *Id.* at 81:16, 21.

Finally, Mr. Denham's opinion – and thus the amount SDCWA demanded to be set aside – did not anticipate that the Court would permit some portion of the disputed rates to be included in a conveyance rate. *See* Statement of Decision of Rate Setting Challenges at 60, 65.

Therefore, the §12.4(c) disputed amount does not represent any estimate of actual damages, and it does not represent the amount needed to put SDCWA in the position it would be in if the contract had been performed as SDCWA contends. In other words, the set aside is not a measure of damages.

III. SECTION 12.4(C) PROVIDES FOR DEPOSITS TO SECURE PAYMENT OF PROPER CHARGES

Section 12.4(c) is a security provision. It provides that, when a dispute over price arises, SDCWA will pay the amount it designates as the "disputed amount," and MWD will deposit that amount in an interest bearing account to secure repayment to SDCWA of overcharges and/or to secure payment to MWD of proper charges. Security provisions are not liquidated damages provisions.

The Law Revision Commission Comments to the 1977 Amendment to Civil Code §1671 are directly on point: "Deposits. Instead of promising to pay a fixed sum as liquidated damages in case of a breach, a party to a contract may provide a deposit as security for the performance of his contractual obligations. . . . *[I]f the parties do not intend that the deposit shall constitute liquidated damages in the event of a breach, the deposit is merely a fund to secure the payment of actual damages if any are determined.*" 13 Cal L Rev Comm'n Rpts 1736, 1752 (1976) (emphasis added).[5] *See also Knight v. Marks*, 66 Cal. App. 593, 599 (1924) (funds held as security deposit, not liquidated damages); *Hanna Nielsen S.S. Co. v. Hammond S.S. Co.*, 32 F.2d 31, 34 (9th Cir. 1929) (deposit found to be "security to assure performance"); *Cal. Contract Litigation* (Matthew Bender 2014), § 7.05[3][c].

Each party's "person most knowledgeable" as to the negotiation, drafting, terms and interpretation of the Exchange Agreement confirmed what the contract says, *i.e.*, that §12.4(c) is

[5] The California Law Revision Commission's report is given "substantial weight" by the courts. *See Util. Consumers' Action Network, Inc. v. AT&T Broadband of S. California, Inc.*, 135 Cal. App. 4th 1023, 1029 (2006).

not a damages clause. SDCWA's outside counsel and "person most knowledgeable," Scott Slater, testified:

> Q. Do you view [12.4(c)] as a liquidated damage provision?
>
> [A.] Lawyers – lawyers draft the way they wish to draft. I think what we intended was that Met – if there was a dispute, that San Diego should not withhold and enjoy the benefit of the amount that was to be requested. So they had to tender, if you will, into escrow that value to make the good faith payment so that – so that they were demonstrating that they could and would pay, and not benefit in the interim period. Likewise, Metropolitan, could not have the benefit of the cash if the bill was incorrect. So by putting it into the deposit or into the third-party fund, neither side was benefited during the interim period. So at the conclusion of the litigation, then those funds would be released, the conclusion of the dispute. I don't know that that's a liquidated damage because in my – in my experience, liquidated damages, you're trying to ascertain the full damage, which in some cases is difficult to calculate. . . .
>
> * * *
>
> Q. Do you recall any specific instance in which anybody referred to this as a liquidated damage provision in connection with the negotiations of either the '98 or the 2003 agreements?
>
> A. I don't recall that nomenclature.

Slater Depo. at 143:4-144:2; 148:20-24, attached to Borden Decl. as Ex. N.

MWD's former Assistant General Manager and "person most knowledgeable," Brian Thomas, testified to the same effect (*i.e.*, that §12.4(c) does not fix the amount of damages):

> Q. And likewise, the requirement that if the Water Authority wins on the price dispute, they then receive the disputed amount, that too seemed fair to Met?
>
> A. Not exactly. What would be envisioned is that, for instance, if San Diego said they overpaid by $100, we resolve the dispute and they overpaid by $50, they would get the $50 plus whatever interest accrued to the $50.
>
> Q. I see. So the Water Authority gets the portion of – according to Metropolitan's interpretation, *the Water Authority gets the portion of the disputed amount on which it prevails*?
>
> A. *Yes*.
>
> * * *
>
> Q. Where is that reflected in Section 12.4(c)?
>
> A. [T]he way we interpret this is, if San Diego prevails, it's the amount at which they prevail. It would be illogical for them to dispute $100, have a court say it should be $1, and just because they disputed it, Met would return $100 . . . .

Thomas Depo. at 157:19-158:11; 163:17-164:1 (emphasis added), attached to Borden Decl. as Ex. O.

The genesis of §12.4(c) also is consistent with its language. SDCWA's Mr. Slater testified:

> Q. What was the concern motivating the inclusion of this? You said it was [SDCWA General Counsel Daniel] Hentschke's idea; right?
>
> A. Yeah. The genesis of this, we have to go back to we all learn by history and our experience. . . . I represented Burbank, Glendale, Beverly Hills, and Universal Studios in the suit against the City of Los Angeles over the Hyperion wastewater facility. And those negotiations were influenced by the refusal of the agencies to pay anything to the City of Los Angeles under the dispute provisions. So they were all sending their sewage into the City of Los Angeles' Hyperion Treatment Facility and not paying anything while the matter was in dispute. And this became a real sore spot for the City of Los Angeles, but ultimately put pressure on the City to try to resolve it. And we knew -- everybody understood that experience and that tactic. And there was a -- sort of a back and forth about whether you could withhold payment if there was a dispute, the extent of -- to which you could withhold. And this provision was largely seen as a balance to avoid either side gaming that point.
>
> * * *
>
> Q. Did any party, in connection with the negotiation of this provision, call it a liquidated damages provision to your recollection?
>
> A. In my recollection, the focus was not allowing San Diego to do what the contract agencies did to Los Angeles, and vice versa, not allowing Los Angeles to have -- and I'm not picking on L.A. Okay? I'm just saying, under that circumstance -- right? -- the idea that they would have the revenue while the dispute was going on, it was wrong on both sides. Moreover, we thought having the money in the pot would enhance the prospect of settlement. I don't recall the discussion around liquidated damages.

Slater Depo. at 142:1-25 and 148:5-17, attached to Borden Decl. as Ex. N.

MWD's Mr. Thomas testified, consistently with Mr. Slater, that §12.4(c) was not drafted to set the measure of damages:

> Q. And what was the understanding of the parties as to why §12.4(c) was an appropriate way to handle this problem?
>
> A. The discussion that I recall in – we were trying to be consistent with how Metropolitan charges its rates and charges. And the way it works for regular deliveries is: When Metropolitan delivers water and presents a bill, the member agencies pay, and then there's a dispute process. And if it's resolved in the member agency's favor, we would return, as a credit typically on a bill, whatever the difference was. In this case, the Water Authority was again trying to be consistent with that, but the Water Authority said: Listen, we want to make sure we get our money, should we win, and we would like that money segregated so

> Met couldn't spend it on other things; and we want it set up in a separate account and earning that interest until it's resolved.

Thomas Depo. at 156:16-157:12, attached to Borden Decl. as Ex. O.

Significantly, in SDCWA's letters to MWD concerning the deposits under §12.4(c), there is no mention of damages; SDCWA simply demanded that MWD deposit the funds in an interest bearing account which it called an "Escrow Account." In contrast to its recent arguments in this Court, SDCWA acknowledged that it would *not* be entitled to the entire "disputed amount" even though the Exchange Agreement required that the entire amount be put in "escrow." Specifically, SDCWA represented:

> Pursuant to section 12.4(c) of the Exchange Agreement, the Water Authority hereby makes formal demand that Metropolitan establish a separate interest bearing account for the deposit of the Disputed Amount as defined below ("Escrow Account"). Pursuant to section 12.4(c), the funds in the Escrow Account may not be used by Metropolitan until there has been a resolution of the Rate Case. . . . *The Water Authority recognizes that a small portion of the $37,824,313 overpayment would be reallocated to the Water Authority through payments made for its purchases of Metropolitan supplies, but the Exchange Agreement requires escrow of the entire Disputed Amount*.

Hentschke Letter dated 2-10-11 (emphasis added), attached to Borden Decl. as Ex. P.

IV. SECTION 12.4(C) IS NOT A LIQUIDATED DAMAGES CLAUSE

SDCWA argues that §12.4(c) is "akin" to a liquidated damages clause and that MWD, therefore, has the burden of proving its unenforceability under Civil Code §1671(b). But SDCWA has the cart before the horse. Section 1671(b) expressly applies only to an actual liquidated damages clause, *i.e.*, a provision "liquidating the damages" for breach of contract. The threshold question is whether §12.4(c) *is* a liquidated damages clause. It is not.

A. Section 12.4(c) Does Not State a Liquidated Amount.

The essence of a liquidated damages clause is, self evidently, that the amount of damages be "liquidated," *i.e.*, "*fixed and certain by agreement*." In *ABI, Inc. v. City of Los Angeles*, the Court of Appeal held that a contract provision did not satisfy the "threshold" requirement that there be a liquidated amount: "[T]he *sine qua non* for this favorable treatment to operate is a requirement that the contract contain a meaningful provision for liquidated damages, which

normally stipulates a pre-estimate of damages in order that the parties may know with reasonable certainty the extent of liability for a breach of their contract. . . ." 153 Cal. App. 3d 669, 684-85 (1984). Similarly, in *Chodos v. West Pub. Co.*, the Ninth Circuit wrote that "California courts have defined [liquidated damages] as 'an amount of compensation to be paid in the event of a breach of contract, the sum of which is *fixed and certain by agreement* . . . .'" 292 F.3d 992, 1002 (9th Cir. 2002) (emphasis added); *see also Ruwe*, 613 F. Supp. 2d at 1196-98 (liquidated damages must be "*fixed and certain by agreement*") (emphasis added).

There is no liquidated amount in the Exchange Agreement. Section 12.4(c) does not contain a fixed or certain sum or any formula or method for calculating a fixed or certain sum. Under §12.4(c), SDCWA *unilaterally* chooses any amount it desires when a dispute arises. There are no limits on its discretion. There are no criteria at all.

SDCWA apparently contends that the amount it demanded to be set aside satisfies the requirements of a reasonable, liquidated amount. It does not, for two reasons: First, the amount was chosen unilaterally by SDCWA; it is a "disputed amount," not an agreed amount. Second, SDCWA chose this amount years after the contract was made. The validity of a liquidated damages clause is determined as of the time the contract was formed. Civil Code §1671(b); *see also Ridgley v. Topa Thrift & Loan Ass'n*, 17 Cal. 4th 970, 977 (1998); *Lowe v. Mass. Mut. Life Ins. Co.*, 54 Cal. App. 3d 718, 735 (1976). It does SDCWA no good to argue that in 2011 it demanded a fixed amount. That is over seven years too late. The issue is whether the parties agreed to a reasonable amount in 2003 when the contract was made. Back then, SDCWA had not demanded, and MWD had not agreed to, any amount as an estimate of damages.

Because there is no liquidated amount, §12.4(c) is not a valid liquidated damages clause.

B. Section 12.4(c) Has None of the Language of a Liquidated Damages Clause.

Section 12.4(c) has none of the core terms included in liquidated damages clauses. Not only is there no fixed or certain amount, there is no reference to "liquidated damages" (or even to "damages"), and there is no statement that actual damages are difficult to ascertain. *Compare, e.g.*, *Utility Consumers' Action Network, Inc.*, 135 Cal. App. 4th at 1026 (contract stated that

charges were "'liquidated damages intended to be a reasonable advance estimate of our costs resulting from late payments or non-payments by our customers, which costs will not be readily ascertainable, and will be difficult to predict or calculate'"); *Better Food Markets v. Am. Dist. Tel. Co.*, 40 Cal. 2d 179, 184 (1953) (contract provided that "it is impracticable and extremely difficult to fix the actual damages" and, in case of failure to perform, "liability hereunder shall be limited to and fixed at the sum of fifty dollars as liquidated damages").

In *ABI,* the Court of Appeal wrote: "If the City wanted to claim the developer fee as liquidated damages, it should have written the instrument to say so in a manner which would *clearly express this intention*. The language used is far from purporting to be a pre-estimate of damages for breach of contract. . . . These deficiencies manifest that the language in question cannot effectively qualify as a provision for the liquidation of damages." 153 Cal. App. 3d at 685 (emphasis added).

C. The Parties Did Not Intend That Section 12.4(c) Be the Measure of Damages.

The object of contract interpretation is to ascertain the intent of the parties. *Pac. Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 38 (1968). In particular, whether a contract contains a valid liquidated damages clause depends on the parties' intent. *See Harbor Island Holdings v. Kim*, 107 Cal. App. 4th 790, 797 (2003) (intent to approximate damages is "required for the clause to be held a valid liquidated damages clause"); *Los Angeles City School Dist. v. Landier Inv. Co.*, 177 Cal. App. 2d 744, 753 (1960) (whether provision is valid agreement for liquidated damages "depends on the intent of the parties").

The testimony of the "persons most knowledgeable" for both parties quoted in § III above shows that the parties did *not* intend that §12.4(c) be a liquidated damages (or any damages) provision (*e.g.*, "I don't recall that nomenclature.").[6] *See* pp. 7-9, *supra.* Indeed, SDCWA has not

[6] Under the parol evidence rule, extrinsic evidence may not be admitted to vary, alter or add to the terms of a fully integrated contract. Code of Civil Procedure §1856. *See also Casa Herrera, Inc. v. Beydoun*, 32 Cal. 4th 336, 343 (2004). However, in the event of ambiguity, the parol evidence rule does not prohibit the introduction of extrinsic evidence to explain the meaning of a term to which the contract is reasonably susceptible. *See Morey v. Vannucci*, 64 Cal. App. 4th 904, 912 (1998). Here, MWD (like SDCWA has done in the past) offers parol evidence to explain the meaning of §12.4(c) if the Court finds it to be ambiguous, not to vary, alter or add to its terms.

presented *any* evidence that, in connection with the negotiation or drafting of the Exchange Agreement (or its predecessor, the 1998 Exchange Agreement), anyone ever considered §12.4(c) to be a liquidated damages clause (or that it provided any measure of damages).

D. Even If Section 12.4(c) Were a Liquidated Damages Clause, It Would Be Unenforceable.

Civil Code §1671(b) provides that a liquidated damages clause is unenforceable if it was "unreasonable under the circumstances existing at the time the contract was made." The amount of liquidated damages must bear a "*reasonable relationship to the range of actual damages*" anticipated at the time of formation of the contract to flow from a breach. *Ridgley*, 17 Cal. 4th at 977-78 (emphasis added); *see also Greentree Fin. Group, Inc. v. Execute Sports, Inc.*, 163 Cal. App. 4th 495, 499-501 (2008) (liquidated damages clause is unenforceable if damages bear no reasonable relationship to anticipated range of actual damages). In the absence of such a relationship, a liquidated damages clause "must be construed as a penalty" and the plaintiff can collect only "actual damages sustained." *Id.* (citing *Ridgley*, 17 Cal. 4th at 977).

A "reasonable relationship" contemplates a comparison of two amounts: the liquidated amount and the anticipated range of actual damages. *Ridgley,* 17 Cal. 4th at 977. Here, there was no liquidated amount. And, in October 2003 when the contract was formed, the parties did not attempt to anticipate the range of actual damages for future disputes.[7] Thus, there is, and can be, no "reasonable relationship" – or any relationship at all – between these amounts because there was neither a liquidated amount nor an anticipated range of actual damages. *See Smith v. Royal Mfg. Co.*, 185 Cal. App. 2d 315, 323-24 (1960) (where sum is fixed as liquidated damages "for one of several breaches of varying degree," it is unenforceable); *see also Harbor Island Holdings*,

[7] Section 12.4(c) concerns price disputes generally. A price dispute can relate to any number of different types of events (particularly given the 35 or 45 year term of the Exchange Agreement), including mathematical calculations, disputes or alleged errors as to the amount of water delivered, *etc*. It is not limited to a dispute about whether MWD's conveyance charges are lawful. Consequently, the parties did not even attempt to anticipate the nature of any future disputes at the time of contract formation.

107 Cal. App. 4th at 796-97 (liquidated damages clause was unenforceable penalty because liquidated amount would have to be paid in the event of "any breach").

Thus, even if §12.4(c) were considered a liquidated damages clause, it would not have been reasonable under the circumstances existing at the time the Exchange Agreement was made and it would, therefore, be unenforceable. *See Purcell*, 224 Cal. App. 4th at 974 (in the absence of a reasonable relationship between liquidated damages and actual damages, a liquidated damages clause "will be construed as an unenforceable penalty"); *Morris v. Redwood Empire Bancorp*, 128 Cal. App. 4th 1305, 1314 (2005) (same).

V. THE USE OF SECTION 12.4(C) AS THE MEASURE OF DAMAGES WOULD CONSTITUTE A FORFEITURE

California has a strong public policy against forfeitures. *See ABI,* 153 Cal. App. 3d at 681-82. In the context of damages for breach of contract, Civil Code §3358 provides:

> Except as expressly provided by statute, no person can recover a greater amount in damages for the breach of an obligation, than he could have gained by the full performance thereof on both sides.

See also California Breach of Contract Remedies (CEB 2006), § 1.21.[8]

A damages provision is an unenforceable forfeiture when the amount to be paid is determined without regard to the actual damages to be suffered. *McGuire v. More-Gas Invs., LLC*, 220 Cal. App. 4th 512, 522 (2013) (damages which are disproportionate to anticipated actual damages would be an unenforceable penalty rendering the provision ineffective); *Poseidon Dev., Inc. v. Woodland Lane Estates, LLC*, 152 Cal. App. 4th 1106, 1115 (2007) (payment made without regard to actual range of damages is an unenforceable penalty); *Harbor Island Holdings*, 107 Cal. App. 4th at 797 (provision by which money is paid without regard to actual damage is unenforceable).

[8] SDCWA has not cited any statutory (or other) exception to Civil Code §3358. *Compare Pelletier v. Eisenberg*, 177 Cal. App. 3d 558, 567-68 (1986). Civil Code §1671 does not provide such an exception; rather, it requires a reasonable relationship between the liquidated amount and the anticipated actual damages. *See* § IV.D., *supra.*

SDCWA asserts that it is entitled to recover the entire amount it chose to dispute even if it loses on some or most of its claim. Under that logic, if it were to prove overcharges of $1 million, it would be entitled to recover $150 million if that were the amount it chose to dispute. Perversely, SDCWA would have a financial incentive to inflate its claim; the larger the set aside it demanded, the higher its recovery, without regard to the merits. SDCWA would get a windfall for disputing a high number (even if not justified) if it prevailed as to any part of its claim.

Thus, §12.4(c) would cause a forfeiture if enforced as a measure of damages.

Conclusion

For the foregoing reasons, §12.4(c) is not enforceable as a measure of damages; rather, the proper measure of damages is general compensatory damages under Civil Code §3300.

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