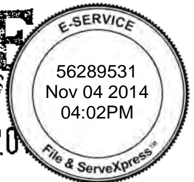
FILED
San Francisco County Superior Court
NOV 4 - 2014
CLERK OF THE COURT
BY: Deputy Clerk



SUPERIOR COURT OF CALIFORNIA

COUNTY OF SAN FRANCISCO

SAN DIEGO COUNTY WATER AUTHORITY, Plaintiff/Petitioner, vs. METROPOLITAN WATER DIST. OF SOUTHERN CALIFORNIA, et al. Defendants/Respondents.	Case No. CPF-10-510830 Case No. CPF-12-512466 ORDER RE MEASURE OF DAMAGES (SECTION 12.4(c) EXCHANGE AGREEMENT)

The San Diego County Water Authority challenged the rates set by the Metropolitan Water District of Southern California (Met) and asserted a claim for breach of contract. I bifurcated, designating the breach of contract causes of action for trial at a date following resolution of the rate challenges. Trial on the rate challenges commenced on December 17, 2013, and I invalidated the System Access Rate, System Power Rate, Water Stewardship Rate, and wheeling rate.

Now the parties ask me to decide whether § 12.4(c) of the Exchange Agreement, the contract underlying the breach of contract claim, fixes the damages to be awarded if Met is liable for breach of contract. Met and San Diego have each provided parol evidence to explain the terms in the Agreement.

Discussion

A. Basic Law

The determination of whether an ambiguity exists is a question of law. *Wolf v. Superior Court*, 114 Cal.App.4th 1343, 1350-51 (2004) If no parol evidence is admitted or the parol evidence is not in conflict, the resolution of the ambiguity is also a question of law. *Id.*

A provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable at the time the contract was made. Civ. Code § 1671(b). The provision is generally unreasonable and unenforceable if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. *Harbor Island Holdings v. Kim*, 107 Cal.App.4th 790, 796 (2003). Whether an amount to be paid upon breach is to be treated as liquidated damages or as an unenforceable penalty is a question of law. *Id.* at 794.

B. Contractual Language

The Exchange Agreement provides for the price term as follows: "The Price on the date of Execution of this Agreement shall be Two Hundred Fifty Three Dollars ($253.00). Thereafter, the price shall be equal to the charge or charges set by Metropolitan's Board of Directors pursuant to applicable law and regulation and generally applicable to the conveyance of water by Metropolitan on behalf of its member agencies." Exchange Agreement § 5.2.

This is the provision that is the focus of the present dispute:

> 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 § 12.4(c).

If a party's position on price is vindicated – for example, if San Diego's proposed price or Met's proposed price is adopted by a court – then that party has likely 'prevailed' in the dispute and is entitled to the money in the pot. But that has not happened here.

The meaning of the term "prevails" is ambiguous.

San Diego's position is that San Diego has "prevailed" because it showed that the manner in which Met reached its asserted price was unlawful. Therefore, as a prevailing party, San Diego contends that it is entitled to the entire disputed amount whether or not its own view of the price is correct. *See* San Diego Opening Brief, 3, 5; *see also* Exchange Agreement § 5.2.[1] Under this theory, § 12.4(c) is a liquidated damages provision, or other damages provision, under which San Diego is entitled to the difference between what it believes the price should have been and the price it paid if it can show that Met's price was unlawfully reached. This reading avoids any difficulties that arise from attempting to ascertain what an appropriate or lawful price would have been.

To prevail in whole, on Met's reading, San Diego must show that the price it asserted is in fact the appropriate price. Under Met's theory, both sides may prevail in part if the appropriate price is determined to be between the positions staked out by the parties. Met Opening Brief, 8 (citing Borden Declaration, Ex. O). In such cases San Diego is entitled to only the difference between the appropriate price and the price actually charged. *Id.* In Met's view, § 12.4(c) is a security provision and as such § 12.4(c) ensures that both: (1) San Diego will be able

[1] San Diego also emphasizes that the "shall forthwith pay the disputed amount" language is unambiguous. San Diego Reply, 9-10. True, but the language is triggered only if San Diego 'prevails'.

to recover whatever it proves it is entitled to in a price dispute; and (2) Met will be able to recover whatever payments it is entitled to in a price dispute. *Id.* at 9 (citing Borden Declaration, Ex. N-O). This avoids two problematic scenarios: (1) San Diego pays the full amount and sues to challenge the rates, Met spends the money, and San Diego is unable to collect even if it demonstrates the price was too high; and (2) San Diego refuses to pay the full amount of the price while spending its remaining funds elsewhere, Met sues to collect the remainder of the payments owed and wins, but Met is unable to collect. *Id.* As discussed below, § 12.4(c) also precludes each side from benefitting from the funds pending a dispute, thereby gaining leverage in a dispute.

The contract is ambiguous, both readings above are reasonable. *Wolf*, 114 Cal.App.4th at 1350-51. I turn to extrinsic evidence.

Met's person most knowledgeable, who was involved in negotiating the contract, testified that Met's reading was in fact what the parties intended. Met Opening Brief, 8; Borden Declaration, Ex. O.[2]

San Diego's person most knowledgeable, Scott Slater, described the origin of the provision in more detail. Borden Declaration, Ex. N at 142:1-148:24. Slater explained that the reason the parties included the provision was to prevent either party from having the benefit of the cash in the interim period. *Id.* at 142:1-143:23. The negotiations on this point were influenced by a dispute in which Los Angeles had been forced to process sewage without being paid, during the course of a price dispute. *Id.* at 142:11-20, 148:8-17. The provision was seen as a balance to prevent both sides from gaming the point. *Id.* at 142:24-25. Slater acknowledged

[2] Brian Thomas, Met's person most knowledgeable, stated at his deposition that if San Diego prevails in the price dispute then the "amount that they prevail on would be given to [San Diego] along with all interest earned." Borden Declaration, Ex. O at 155:19-23. Further, Thomas testified at his deposition that "[w]hat 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." *See* Borden Declaration, Ex. O at 157:19-158:11.

that the parties did not address who is "prevailing" and did not address, for instance, the proper procedure for resolving a dispute on price that involves multiple sub-issues some of which may be decided in favor of one side and some in favor of the other. *Id.* at 144:22-146:14. This evidence suggests that the failure to address a situation in which both parties prevailed was not an attempt to create a winner-take-all damages provision, but that the intent of the provision was simply to deprive both sides of the use of the disputed funds during a dispute (although the parties failed to account for the possibility that each side might prevail in part).

The only persuasive parol evidence offered in this case is the deposition testimony provided by Slater and Thomas.[3] They are consistent on the point that the primary purpose of § 12.4(c) was to ensure that neither side could use disputed funds while the lawsuit was ongoing. Borden Declaration, Exs. N at 142:1-143:23, 148:5-17, O at 156:16-157:12.

Thomas characterized § 12.4(c) as paralleling Met's normal bill dispute resolution process, except that the provision requiring payment of funds "forthwith" precluded Met from using its normal practice of affording the member agency a credit on future bills. *Id.*, Ex. O at 156:16-157:12, 164:10-21.

Slater's testimony may partially contradict Thomas' testimony by suggesting that § 12.4(c) may have been an attempt to fix damages. For example, Slater suggested that in an invoice dispute one is not suing for breach and there are no other damages available. *See id.*, Ex. N at 146:20-147:24, *see also* 143:3-14 ("I guess you could characterize this as a form of damage,

[3] San Diego offers a letter, written eight years after the parties entered the contract, in which Met asserted that it was under no obligation to refrain from using funds deposited in the separate account. Jackson Declaration, Ex. I. (This issue is slightly tangential to the specific issue decided in this Order.) Presumably the letter is offered to contradict the consistent statements by both Slater and Thomas regarding the intent of the parties at the time the contract was drafted (Borden Declaration, Exs. N at 142:1-143:23, O at 157:8-12). But statements of Slater and Thomas are far more persuasive with respect to whether Met was precluded from spending funds held in the separate account. San Diego also contends that Met has conceded, in statements to bondholders, that San Diego will be entitled to the disputed funds if San Diego prevails. San Diego Opening Brief, 14 (citing Jackson Declaration, Ex. C at A-49). But this merely restates the contract, and sheds no light on what it means to 'prevail' in litigation.

but I just viewed it as the disputed amount. And – and if the – if the allegation was correct, that it was improperly charged, the money would be returned because it had been paid improperly and – or invoiced improperly. And if it was correctly billed, then the entity, Metropolitan, would receive the full benefit of it").

Slater also asserted that, although "prevailing" is not defined in the contract, one could allocate the amounts in dispute on various issues as earmarked funds to operationalize § 12.4(c) as a measure of damages in such circumstances. *Id.*, Ex. N at 144:22-146:14. Nevertheless, Slater made it clear that he did not know, and did not give much thought to, whether § 12.4(c) was a liquidated damages provision and could not recall whether any party used the term liquidated damages while negotiating § 12.4(c). *Id.*, Ex. N at 147:16-20, 148:5-24.

I conclude that §12.4(c) was not intended to fix the amount of damages in price disputes.

First, I note that "prevails" is not defined. If the parties had agreed to a clause fixing damages in a winner-take-all fashion, one would expect to find a definition of what condition must be satisfied to win. On the other hand, if the parties intended only to ensure (i) funds were not used until the dispute was resolved and the (ii) payment of funds to the winner was done promptly upon resolution of the suit, one would not expect to find a definition of "prevails" because the prevailing party would be determined through the dispute resolution process.

Second, the absence of a definition of "prevails" is at least consistent with an agreement that the parties would divide the funds if both were partially successful. Thomas asserts that both parties understood that prevailing in part was a possibility. Borden Declaration, Ex. O at 156:16-158:11, 162:12-164:10-21. Slater, despite his assertion that § 12.4(c) may fix the amount of damages, states that the contract does not address who is prevailing and that typically judges

decide who prevails. *Id.* Ex. N at 145:12-19. Nothing in the contract precludes a scenario in which both parties prevail in part.

Third, the record (consistent with the language of the contract), demonstrates that the primary purpose of § 12.4(c) was to prevent either side from spending disputed funds during the pendency of a dispute and to ensure that disputed funds were promptly available to the prevailing party upon the resolution of a dispute. Substantial evidence indicates that, in view of the unresolved ambiguity with respect to the term "prevails," the parties did not intend to go further and fix the amount of damages through § 12.4(c). Rather, the damages were left to be resolved through a dispute resolution process, such as by litigation.

Fourth, San Diego's reading is unreasonable. It allows San Diego to *fix* extraordinarily high damages through the simple expedient of *claiming* extraordinarily high damages. Even if the claim is made in good faith, it could, consistent with San Diego's reading of the provision, in 'good faith' be based on San Diego's view that Metropolitan had improperly billed for a variety of components whereas ultimate liability might be predicated solely on one such component, thereby again imposing vastly disproportionate damages. It is highly unlikely this reading is consistent with the parties' intention in drafting the Agreement, and no extrinsic evidence suggests such an intent.

For all these reasons I reject San Diego's reading of the provision. This conclusion is sufficient to resolve the present dispute: San Diego may not rely on § 12.4(c) to fix damages.

C. Enforceability of § 12.4(c) as a Provision Fixing Damages

1. As a Liquidated Damages Provision

While the discussion above is enough to resolve the present dispute, I address a few related issues, and conclude here that § 12.4(c) is not enforceable because the parties did not tie §

12.4(c) to any reasonable estimate of the amount of damages, but instead gave San Diego discretion to determine the damages unilaterally.

A liquidated damages clause will generally be considered unreasonable, and hence unenforceable, if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from the breach. *Ridgley v. Topa Thrift & Loan Ass'n*, 17 Cal.4th 970, 977 (1998).

San Diego asserts that there is a reasonable relationship between the liquidated damages amount – the difference between San Diego's asserted price and the price Met actually charged – and the actual damages in a price dispute – the difference between a price set by Met in compliance with the contract and Met's actual price.

But nothing in the contract's wording assures that the price asserted by San Diego will, in fact, be related in any way to a price that Met could have set in compliance with the contract. Recognizing this, San Diego argues that the covenant of good faith and fair dealing assures that San Diego does not inflate its claim. San Diego argues that if the liquidated damages clause might in some circumstances be a penalty, it should nevertheless be judicially reformed and applied in circumstances in which it is not a penalty. *XCO Intern. Co. v. Pacific Scientific Co.*, 369 F.3d 998, 1004-05 (7th Cir. 2004).

For reasons I have provided above, reliance on the covenant of good faith does not save the situation. If San Diego makes a good faith mistake of law or fact, its proposed price may be profoundly wrong, and entirely disproportionate, with the actual damages suffered. Nothing in the contract guards against this.

Here, § 12.4(c), if it was intended to serve as a liquidated damages clause, is not an attempt to estimate the loss occasioned by a breach of Met's obligation to set a price in

compliance with law, but an agreement that gives San Diego unilateral discretion to estimate the loss. Such a provision is not enforceable. *See Lowe v. Mass. Mutual Life Ins. Co.*, 54 Cal.App.3d 718, 737 (1978); *McGuire v. More-Gas Investments, LLC*, 220 Cal.App.4th 512, 522 (2013).

San Diego argues that because it would be extremely difficult, if not impossible, to ascertain the actual damages in this case a greater range of estimates should be treated as reasonable. But the problem here is that the parties did not together estimate damages in the Exchange Agreement, but instead gave San Diego discretion to estimate damages in the future. This is not a proper means of contracting for liquidated damages.[4]

2. Other Provision Fixing Damages or as Alternative Performance

San Diego argues that § 12.4(c) need not be viewed as a liquidated damages provision, but that it can be enforced as some other damages provision or as an alternative means for Met to perform its obligations under the contract. These appear to be the same argument. San Diego relies on *Chanan Singh v. Cross*, 60 Cal.App. 309, 318-19 (1922), where the parties agreed that if the lessors breached their contractual duty to furnish water in time, lessee's would be entitled to the costs of work performed up to that time by lessee's plus 10% as full compensation. *Chanan Singh*, 60 Cal.App. at 318. The parties disputed whether the provision was one for liquidated damages or a provision for an option. *Id.* at 318-19. The Court concluded, without

[4] San Diego argues that it does not matter whether the liquidated damages are themselves fixed in the contract so long as the amount of liquidated damages can be ascertained without judicial determination. San Diego Opening Brief, 14-15, citing *Chodos v. West Publishing Co.*, 292 F.3d 992, 1002-03 (9th Cir. 2002). San Diego then argues that the disputed amount is certain and has been certain since San Diego submitted its view of the price and Met accepted it. *See id.* at 15 (disputed amount is reflected in Met's statements to bondholders). The cited portion of *Chodos* discussed liquidated debts. In any event the problem here is that the parties did not attempt to estimate a damage amount or a means for calculating a damage amount in the contract, but instead authorized one party to the contract to unilaterally fix a damage amount in the future. The record does not allow me to find that Met's 'acceptance' of San Diego's view of the price for purposes of funding the escrow —an 'acceptance' long after the contract was agreed to—is tantamount to a preclusive admission that San Diego's view of damages is binding. Nor does this record show that the parties at the time of contracting contemplated this sort of post hoc agreement binding the loser on any disputed issue to give up all claim to all funds in the pot.

1 further explanation, that the categorization was immaterial because either way the contract was
2 enforceable. *Id.* at 319. San Diego also argues that what appears to be an improper liquidated
3 damages provision may instead be a permissible requirement for alternative performance.
4
5 It is true that an option to fulfill a contractual obligation by alternative performance does
6 not impose damages and is not subject to limitations on liquidated damages. *McGuire*, 220
7 Cal.App.4th at 522-23. But, when "it is manifest that a contract expressed to be performed in the
8 alternative is in fact a contract contemplating but a single, definite performance with an
9 additional charge contingent on the breach of that performance, the provision cannot escape
10 examination in light of pertinent rules relative to the liquidation of damages." *Id.* at 523. Here,
11 if § 12.4(c) requires the payment of the disputed amount, it is manifest that Met is required to
12 perform the contract by setting a lawful price, and that paying the disputed amount is not an
13
14 alternative performance but an additional charge contingent on the Met's breach of its obligation.
15
16 **Conclusion**
17
18 Section 12.4(c) does not provide a mechanism to set the damages in a dispute over price.
19 Further, even if it did so qualify, § 12.4(c) would be unenforceable.
20
21
22 Dated: November 4, 2014

23 Curtis E.A. Karnow
Judge Of The Superior Court
24
25
26
27

Superior Court of California
County of San Francisco

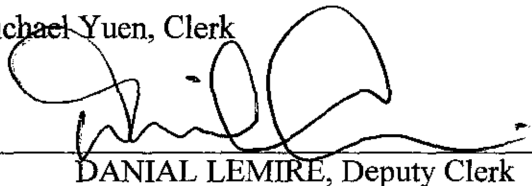
SAN DIEGO COUNTY WATER AUTHORITY, Plaintiff(s) vs. METROPOLITAN WATER DIST. OF SOUTHERN CALIFORNIA, et al Defendant(s)	Case Number: CPF-10-510830 CPF-12-512466 **CERTIFICATE OF ELECTRONIC SERVICE** (CCP 1010.6(6) & CRC 2.260(g))

I, DANIAL LEMIRE, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On November 4, 2014, I electronically served THE ATTACHED ORDER via File & ServeXpress on the recipients designated on the Transaction Receipt located on the File & ServeXpress website.

Dated: November 4, 2014

T. Michael Yuen, Clerk



By: ______________________
DANIAL LEMIRE, Deputy Clerk