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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

Hon. Curtis E.A. Karnow
Date: August 6, 2014
Dept.: 304
Time: 3:00 pm

**RESPONDENT AND DEFENDANT METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA'S CONSOLIDATED REPLY IN SUPPORT OF MOTION FOR LEAVE TO AMEND ANSWERS TO PETITIONS AND COMPLAINTS AND MOTION TO REOPEN EXPERT DISCOVERY FOR LIMITED PURPOSE**

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## Preliminary Statement

According to SDCWA, there is no need for experts, nor even for a Phase II trial at all, because of a purported "liquidated damages clause." Preliminarily, the clause itself does not have any of the language typically used in such a clause. None of the witnesses have called it a liquidated damages clause. SDCWA itself had not previously considered the clause to be a liquidated damages clause. None of its five petitions and complaints asserting a breach of contract claim pleaded liquidated damages; to the contrary, SDCWA pleaded that it would prove compensatory damages at trial. In pre-trial motions, SDCWA argued that it needed discovery to prove the amount of its damages. Finally, even now, SDCWA cannot bring itself to flat out say the clause is a liquidated damages clause. The clause is, according to SDCWA, "akin" to one.

As appellate courts have pointed out, "liquidated damages" are damages that are "fixed and certain." Here, §12.4(c) contains no such certain or fixed damages. SDCWA does not dispute that under the clause it had the unilateral right to assert any amount of "overcharge" without MWD's agreement. SDCWA could pick a grossly inflated amount, a punitive amount or an amount having nothing to do with a reasonable estimate of actual damages, and MWD would have had to set the amount aside.

SDCWA has asked that the clause be evaluated as of the time it was agreed to. Indeed, it should be. At that time, there was no fixed or certain amount set forth, and no way to calculate any amount. Nor does the clause impose any restrictions that would limit SDCWA's demand for a set aside. One party's unilateral right to arbitrarily pick any amount of damages is not reasonable.

Moreover, SDCWA's citations do not support its claim that the parties understood the clause to provide for liquidated damages. The exact opposite. Just one example: SDCWA quotes a portion of Brian Thomas's deposition, but omits that Mr. Thomas said that under the clause MWD would have to pay *only* the amount a court determined it had overcharged. §12.4(c) is simply a mechanism for assuring SDCWA of repayment of overcharges to the extent it "prevails," and to prevail in a breach of contract action requires that it prove damages.

Conspicuously absent from the opposition is any rebuttal to MWD's showing that breach of contract damages are the difference between what SDCWA paid and what it would have paid if

MWD properly performed. Likewise, SDCWA does not deny that this Court has recognized that some amount of the costs that SDCWA challenged could properly be allocated to the rates in issue. Now that the parties have guidance, SDCWA resists having experts render opinions of what the rates could be under the Court's analysis.

As for the motion to amend, SDCWA seeks to adjudicate the defenses without an evidentiary hearing. The undisputed evidence shows SDCWA knew exactly how the rates at issue were calculated before it entered into the 2003 Exchange Agreement. With that knowledge, it nonetheless voted to approve the agreement. The method of calculation did not change between the time SDCWA proposed and agreed to the contract and the time it sued. If SDCWA mistakenly believed the rates were legal, the defense of mutual mistake exists. And if it silently and subjectively believed otherwise, the defense of unilateral mistake applies.

But whether SDCWA genuinely believed the contract was legal or not when entered into, the consideration for the contract was based on what has now been found to be an illegal term. It is hard to imagine a term more essential than price when two public agencies negotiate for the exchange of water over a long period of years in an arid region at a cost of billions of dollars. Suddenly a scarce natural resource may have to be delivered at a dramatically low price. A public agency like SDCWA should not be permitted to exploit a highly technical illegality, which it failed to disclose, so as to benefit its constituents at the expense of the millions of others who would have to pay more.

## Argument

### I. Experts Are Necessary to Determine Damages

As the Court knows, MWD contends that to determine damages the Court would have to set replacement rates and a court has no jurisdiction to do so. MWD contends that SDCWA's contract claim must be dismissed because SDCWA cannot establish the required element of damages until the Court of Appeal rules and MWD's Board sets replacement rates, if required to do so. Contrary to SDCWA's assertions, this is hardly a new position by MWD or by SDCWA. SDCWA's own person most knowledgeable testified that damages, if any, would only be known

after MWD's Board sets replacement rates. *See* Cushman Deposition at 422:7-10, 14-19, 443:20-444:2, attached to Declaration of Kara Borden ("Borden Decl.") as Ex. A.

In any event, if the Court does proceed with the breach of contract trial, it should have the benefit of expert opinion on cost allocation and rate structures – the type of information a board would have if it were establishing a replacement rate structure and setting rates based on it. There is no other way for the Court to determine damages.

**A. §12.4(c) Is Not a Liquidated Damages Clause**

SDCWA does not, and cannot, dispute the showing in the moving papers concerning the measure of damages which is the difference between the rates that SDCWA paid and the rates it would have paid if MWD had "performed properly," *i.e.* set the rates lawfully. To avoid having to prove an element of its case, SDCWA contends that damages were liquidated under §12.4(c). According to SDCWA, §12.4(c) is "akin" to a liquidated damages clause and, under Civil Code §1671(b), MWD has the burden of proving the unenforceability of the clause. But SDCWA has the cart before the horse. §1671(b) applies only to a "*provision in a contract liquidating the damages* for the breach of the contract." (emphasis added). The threshold question is, consequently, whether §12.4(c) *is* a liquidated damages clause.

**1. §12.4(c) Does Not State a Liquidated Amount**

The essence of a liquidated damages clause is, axiomatically, that damages be "liquidated," *i.e.* "*fixed and certain*." 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 damages clause: "[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 Publishing 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); s*ee also Ruwe v. Cellco Partnership*, 613 F. Supp. 2d 1191, 1196-98

(N.D. Cal. 2009) (liquidated damages consist of an amount of "compensation" which is "*fixed and certain by agreement.*" (emphasis added).

Here, there is *no* liquidated amount. §12.4(c) does not contain a fixed or certain number nor any formula, method or procedure for calculating a fixed or certain amount. Under §12.4(c), SDCWA simply *unilaterally* chooses – years after the contract was formed – any amount it desires and demands to be set aside. There are no limitations on its choice. There is no requirement that its demand be reasonable. *There are no criteria at all*.[1]

**2. The Parties Did Not Intend that §12.4(c) Be a Damages Clause**

The object of contract interpretation is to ascertain the parties' intent. *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 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"); *Hanna Nielsen S.S. Co. v. Hammond S.S. Co.*, 32 F.2d 31, 34 (9th Cir. 1929) ("[W]hen we consider the whole contract in an effort to discern the real intent of the parties, we are constrained to the view that it was put up as security to assure performance by the purchaser.").

The testimony of witnesses for both parties shows that the parties did *not* intend that §12.4(c) be a liquidated damages (or any damages) provision.[2] SDCWA has not presented any evidence that anyone ever called §12.4(c) a liquidated damages clause (or even said that it provided for damages of any sort) in the negotiation or drafting of the 2003 Exchange Agreement (or its predecessor, the 1998 Exchange Agreement). It has no letter, email or other communication

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[1] The "disputed amount" later chosen by SDCWA cannot satisfy the requirement of a liquidated amount because the validity of the clause is determined as of the time the contract was formed, seven years before SDCWA chose its "disputed amount." *See* Civil Code §1671(b).

[2] Under the parol evidence rule, extrinsic evidence may not be admitted to vary, alter or add to the terms of a fully integrated contract. Cal. Civ. Proc. Code §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) 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.

in connection with the contract or with setting aside the disputed amount.[3] *See* Slater Deposition at 140:17-142:25; 143:4-144:2; 148:5-149:3; Cushman Deposition at 426:24-427:9, attached to Borden Decl. as Exs. B and A.

In fact, the evidence is to the contrary. SDCWA's outside counsel and person most knowledgeable as to the negotiation, drafting and terms of the Exchange Agreement, Scott Slater, contradicts SDCWA's attempt to characterize §12.4(c) as a liquidated damages clause:

> 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 Deposition at 143:4-144:2; 148:20-24, attached to Borden Decl. as Ex. B.

SDCWA cites the deposition of MWD's person most knowledgeable, Brian Thomas, to argue that MWD had a "clear understanding" that it would pay the *entire* disputed amount to SDCWA if it prevailed in a price dispute. *See* Opp. at 6:14-25. But SDCWA misleadingly excerpted the actual testimony:

> 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.

[3] SDCWA also argues that §12.4(c) requires MWD to "*forthwith pay the entire disputed amount*." Opp. at 9:27-28 (emphasis in the original). But notably absent from §12.4(c) is the word "entire."

> 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. 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 Deposition at 157:19-22, 158:1-11; 156:16-18; 156:22-157:12 (emphasis added), attached to Borden Decl. as Ex. C.[4]

**3. SDCWA Has Never Pleaded that §12.4(c) Is a Liquidated Damages Clause**

A tell-tale sign that SDCWA itself did not believe §12.4(c) was a liquidated damages clause is that SDCWA never claimed liquidated damages in any of its pleadings. A party seeking liquidated damages must plead liquidated damages and the basis therefor. *McCarthy v. Tally,* 46 Cal. 2d 577, 586 (1956); *Util. Consumers' Action Network, Inc. v. AT&T Broadband of S. California, Inc.*, 135 Cal. App. 4th 1023, 1032 (2006). Here, SDCWA not only failed to plead liquidated damages in any of the five complaints in which it asserts breach of damages, *it pleaded the opposite*. It alleged general compensatory damages to be proved at trial and prayed for such relief. *See* First, Second, and Third Amended Petitions and Complaints in the 2010 Action;

[4] *See also id.* at 162:20-163:3 and 163:19-164:1 ("If San Diego prevailed and the Court determined that the appropriate rate was the rate that San Diego calculated, then those amounts would be returned with interest. If the Court determined that a rate – that Met had to recalculate the rate and it turned out to be significantly lower than the rate that San Diego thought was correct, the differential would be returned with interest. . . . [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.").

Petition and Complaint in the 2012 Action; Petition and Complaint in the 2014 Action, attached to Borden Decl. as Exs. D-H.

For example, in its Third Amended Petition and Complaint in the 2010 Action, *filed in 2013*, SDCWA alleged damages as follows: "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 p. 34, ¶ 102, attached to Borden Decl. as Ex. F. 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 p. 39, ¶ 4 (emphasis added); *see also* Petition and Complaint in 2012 Action at p. 34, ¶ 4; Petition and Complaint in 2014 Action at p. 27,¶ 4, attached to Borden Decl. as Exs. G and H.

Furthermore, SDCWA repeatedly represented to the Court that its damages are general compensatory damages and that it would prove the specific amount of its damages at trial. For example, in moving to compel, SDCWA wrote that obtaining information about MWD's actual costs and revenues 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. In another brief, it argued: "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 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.[5]

**4. §12.4(c) Provides for Deposits to Secure Repayment**

[5] On a motion to compel, SDCWA argued "we 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 . . . And that's something that we can't do with what we have right now because we don't understand how the formulas are calculated and how the numbers relate to one another." April 23, 2013 Hearing Transcript at 32:10-22, attached to Borden Decl. as Ex. K. Although SDCWA asserts that it "repeatedly told MWD and the Court it would be relying on the remedy provision in section 12.4(c)," SDCWA repeatedly pleaded and told MWD and the Court that it would prove the amount of its damages in the Phase II trial.

If §12.4(c) is not liquidated damages, what is it? It is a provision under which SDCWA makes deposits to secure payment of damages. *See* Thomas Deposition at 156:16-157:12, attached to Borden Decl. as Ex. C. 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." *See also Knight v. Marks*, 66 Cal. App. 593, 599 (1924) (funds held as security deposit not liquidated damages).

The Exchange Agreement has none of the language of a liquidated damages clause: Not only is there no fixed or certain number, formula or criteria for any liquidated amount, but there is no reference to "liquidated damages" nor a statement that actual damages are difficult to ascertain. In *ABI,* the Court of Appeal stated: "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.

**B. Even If §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." Therefore, 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 v. Topa Thrift & Loan Ass'n*, 17 Cal. 4th 970, 977-78 (1998) (emphasis added). In the absence of such a relationship, a liquidated damages clause "must be construed as a penalty" and "the wronged party can collect only the actual damages sustained. (*Perdue v. Crocker National Bank* (1985) 38 Cal. 3d 913, 931. . . . )" *Id. See also Freedman v. Rector, Wardens & Vestrymen of St.*

*Mathias Parish*, 37 Cal. 2d 16, 20 (1951) (payment made without regard to actual damage is a penalty comprising an unenforceable forfeiture).

A "reasonable relationship" must compare two amounts, *i.e.* the liquidated amount with the range of actual damages. *Ridgley,* 17 Cal. 4th at 977. Here, as of October 2003 when the contract was formed, the parties did not know, nor could they know, how much the price charged in the future might differ from a "lawful rate." The parties could not know future costs nor foresee how they might be allocated. Any amount of liquidated damages could not be reasonably related to actual damages because the range of actual damages was unknown and unknowable. *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 to be inferred that a penalty was intended.").

Thus, §12.4(c) would be unenforceable even if it were a liquidated damages clause. *See Purcell v. Schweitzer*, 224 Cal. App. 4th 969, 974 (2014) (in the absence of a reasonable relationship between liquidated damages and actual damages, a liquidated damages clause "will be construed as an unenforceable penalty.") (internal citations omitted).[6]

**C. The Use of the Disputed Amount as the Measure of Damages Would Constitute a Forfeiture**

A damages provision is an unenforceable forfeiture or penalty when the amount to be paid is determined without regard to the actual damages to be suffered. *See Fox Chicago Realty*

[6] Although the Court examines the purported liquidated damages clause as of the time of the formation of the contract, the positions taken by SDCWA in the litigation ironically illustrate the unreasonableness of treating §12.4(c) as a damages clause. SDCWA purportedly based the "disputed amount" on the sums it paid under the invalidated rates, *i.e.* the System Access Rate (the "SAR"), the Water Stewardship Rate (the "WSR") and the System Power Rate (the "SPR"). But it is undisputed that the measure of actual damages would be the difference between what SDCWA paid and the amount it would have paid if the rates had been set lawfully. However, *SDCWA never accounted for the amount it would have paid under lawful rates.* So, the disputed amount has no reasonable relationship with actual damages. For example, SDCWA contends its challenge to the conveyance rates would shift those costs to the supply rate that it pays for non-exchange water, offsetting the "overpayment" it makes for exchange water, yet it admits that it provided a flawed set-aside number to MWD that did not account for this. *See* Hentschke to Kightlinger Letter, attached to Borden Decl. as Ex. L; Denham Deposition at 91:1-25; 92:18-94:21; 98:23-99:5; 110:15-111:19; 112:19-113:13, attached to Borden Decl. as Ex. M. And there are numerous options for replacement rates, *e.g.* MWD could lawfully set an incremental rate for power which may cost SDCWA as much or more than the SPR so that SDCWA would have *no* damages.

*Corp. v. Zukor's Dresses*, 50 Cal. App. 2d 129, 134 (1942); *Atel Fin. Corp. v. Quaker Coal Co.*, 132 F. Supp. 2d 1233, 1239-41 (N.D. Cal. 2001). Under its interpretation of §12.4(c), SDCWA would recover the entire amount it chose to dispute even if it loses on some or most of its claim. Under SDCWA's logic, if it were to prove overcharges of $1 million, it would be entitled to recover $150 million because that is the amount it chose to dispute. Perversely, under SDCWA's interpretation, it has a financial incentive to inflate its claim; the more it demanded to be set aside, the higher its recovery regardless of merit damages. SDCWA would get a windfall for disputing a high number (even if not justified) if it prevailed as to any part of its claim. Accordingly, §12.4(c) would be a forfeiture.[7]

**D. Expert Testimony Is Necessary to Address the Measure of Damages in Light of the Court's Ruling in Phase I**

The failure of §12.4(c) as a liquidated damages clause mandates that additional evidence be adduced. The measure of actual damages is the amount SDCWA paid MWD less the amount it would have paid upon proper performance, *i.e.* under lawful rates. But there is no evidence in the record as to the rate or rates that MWD's Board would or could have properly set under the Exchange Agreement and consistent with the Statement of Decision. Indeed, the Court, in Phase I, essentially limited consideration of rates to the administrative record before the rate-making body. This limitation was proper in evaluating the rates as set, but not in determining the rates that could be set.

SDCWA argues that MWD "chose to have [its] expert opine that contract damages were incalculable," citing the testimony of Christopher Woodcock. SDCWA omits to mention that Mr. Woodcock was discussing the situation *before* the Court ruled. He testified that "[t]he Court could reject all of SDCWA's claims, it could rule in SDCWA's favor on all of its claims, or it

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[7] Damages are an element of a cause of action for breach of contract and, therefore, SDCWA must prevail on the existence of damages. The reasonable interpretation of §12.4(c) is that MWD must return to SDCWA only that amount of any overcharge on which SDCWA prevails. SDCWA's unsupported theory that MWD must return all of the funds, even if SDCWA did not prevail as to all of the funds, would constitute an unenforceable forfeiture. According to SDCWA, the more inflated and unreasonable its claim, the more money it would get at the end of the day. Such a result was not intended by the parties. *See* Thomas Deposition at 162:13-15, 162:19-163:3, 163:8-9, 163:19-164:1, attached to Borden Decl. as Ex. C.

could accept some of SDCWA's contentions and reject others. . . . *[U]ntil the Court rules*, it is impossible to determine what the damages are, if any." Woodcock Expert Report at p. 25, attached to Borden Decl. as Ex. N (emphasis added). SDCWA's person most knowledgeable on damages agreed. *See* Cushman Deposition at 422:7-10, 14-19, 443:20-444:2, attached to Borden Decl. as Ex. A. Now that the Court has ruled that MWD cannot charge 100% of the State Water Project transportation costs or the conservation and local supply development costs to its conveyance rates, but could charge some lesser percentage, MWD should be permitted to proffer an opinion on those percentages and what reasonable replacement rates could be in light of the Court's rulings.

SDCWA also argues that MWD should not be allowed to reopen expert discovery for the same reason expert discovery was not reopened in *Cottini v. Enloe Med. Ctr.*, 226 Cal. App. 4th 401 (2014). In *Cottini*, the Court disallowed expert discovery because the plaintiff had gambled on a motion to disqualify in lieu of identifying experts. The court found that this type of gamesmanship was "not a good reason to fail to complete discovery during the statutory period for its completion." *Id.* at 421. Here, MWD did not gamble but, instead, engaged in expert discovery. When experts were disclosed and deposed, neither party could have known which costs the Court would determine were allocable to the conveyance rates and which were not and, thus, MWD's expert could not then offer alternative rates. Furthermore, SDCWA had a dry-year peaking claim which was not successful. As MWD informed the Court more than a year ago, MWD needed the Court's ruling to determine damages: "If SDCWA were to prevail in its challenges to MWD's rates, the Court's ruling on the rate challenges would be necessary to inform the theory of contract damages, if any . . . . Without a ruling on MWD's rates, there is no way to determine whether there are any damages." Joint Case Management Conference Statement at 12:9-10, 14-15, attached to Borden Decl. as Ex. O.

Importantly, SDCWA has not identified any prejudice or detrimental reliance if expert discovery is reopened. SDCWA does not assert, for example, that it would be unable to present its own expert testimony or that it changed its position or selected experts in reliance on previous testimony. As the Court of Appeal noted in *Dickison v. Howen*, 220 Cal. App. 3d 1471, 1479

(1990): "A party is not prejudiced simply because the new expert will give testimony adverse to the party. . . ."

In fact, it is mystifying that SDCWA itself has not moved to reopen expert discovery. SDCWA, of course, has the burden of proving damages, and its experts simply assumed that all the challenged costs would be disallowed and could be moved to the supply rate with no impact on SDCWA's overall payment obligations. That assumption proved wrong. Consequently, SDCWA does not have expert testimony consistent with the Court's ruling that some of the challenged costs are properly allocated to the conveyance rates. Therefore, if expert discovery is not re-opened, SDCWA cannot show the difference between what it paid and what it would have paid if the contract had been performed properly - that is, the conveyance rates calculated in accordance with the ruling in Phase I. In addition, SDCWA's expert never calculated the increase in SDCWA's supply rate as a result of the SPR, SAR, and WSR changes, an offset that has to be made in establishing damages. *See* Denham Deposition at 91:1-25, attached to Borden Decl. Ex. M. It hardly makes sense for SDCWA to complain that it will be "prejudiced" by evidence that it must present anyway to prove its case in chief.

Experts on damages are routine. There is no other just way to determine how much of the challenged costs should be allowed in light of the decision by this Court that at least some are allowable. The Court would benefit from testimony that explains how costs could be allocated under the Statement of Decision.

Finally, neither of Cal Civ. Code §§ 2034.620 or 2024.050(a) precludes reopening discovery now to allow for additional expert testimony. MWD, as to this phased proceeding that first considered rate-making and now evaluates contract breach, including damages, has acted with reasonable diligence and SDCWA will suffer no prejudice from the re-opened discovery except as to merits of its damages assertion.[8]

[8] SDCWA asserts that MWD's request for limited expert discovery will cause "a year-long sideshow of irrelevant rate-setting hypotheticals." However, in a Case Management Conference Statement, SDCWA noted that the parties would only need two months "to prepare expert disclosures and complete depositions of experts." *See* Joint Case Management Conference (footnote continued)

## II. Justice Requires Consideration of MWD's Mistake and Illegality Defenses

### A. MWD Has Meritorious Defenses that the Court Should Consider

SDCWA does not dispute that California's strong policy favoring leave to amend applies with particular force where a party seeks to add affirmative defenses. Likewise, SDCWA does not dispute that it is generally an abuse of discretion to deny leave to amend where the opposing party is not prejudiced. *See Kittredge Sports Co. v. Superior Cour*t, 213 Cal. App. 3d 1045, 1048 (1989) ("abuse of discretion to deny leave to amend where the opposing party was not misled or prejudiced"). Importantly, SDCWA does not claim prejudice. Instead, SDCWA claims the defenses lack merit. That is not a basis to deny this motion.

Courts do not decide claims or defenses on the merits on a motion to amend. So long as it reasonably appears from the allegations that a cause of action or defense can be pleaded, leave to amend should be granted. *See Powell v. Lampton*, 30 Cal. App. 2d 43, 47 (1938). The substantive validity of the proffered defense cannot be the basis for denying a motion to amend because "a defendant denied leave to amend is permanently deprived a defense." *Hulsey v. Koehler*, 218 Cal. App. 3d 1150, 1159 (1990); s*ee also Bettencourt v. Hennessy Indus., Inc.*, 205 Cal. App. 4th 1103, 1111 (2012) (trial court abuses its discretion if it denies leave to amend when there is a reasonable possibility that defect in pleading could be cured by amendment).

#### 1. MWD Can State a Defense of Mistake of Law

##### (a) SDCWA Does Not Address Unilateral Mistake

SDCWA claims that the defense of mistake of law should be rejected out of hand because SDCWA now contends that it always believed the 2003 Exchange Agreement was unlawful. That is a remarkable contention. It would mean that SDCWA proposed and entered into a contract to provide water to over three million people for over 100 years, at a cost of billions of rate payer dollars, *knowing* that a core term was unlawful and it was overpaying. In any event, the most

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Statement for July 16, 2013 at 5:3-4, attached to Borden Decl. as Ex. O. There is no reason why additional expert discovery could not be completed in a similar amount of time.

obvious legal flaw in SDCWA's argument is that it ignores one of the alternative bases for the defense of mistake of law, *i.e.* unilateral mistake.

The defense of mistake of law arises *either* where both parties to a contract made the same mistake or where one party made a mistake and the other party was aware of the mistake and *did not rectify it*. Civil Code §1578; *see also In re Peterson's Estate*, 259 Cal. App. 2d 492, 504-05 (1968) (defense established where party did nothing to rectify unilateral mistake of law); *Simmons v. Briggs*, 69 Cal. App. 447, 461-62 (1924) (same). Accordingly, if, as it now argues, SDCWA truly believed in 2003 that the rates were unlawful, it was obligated to "rectify" MWD's mistake. SDCWA failed to rectify any mistake. To the contrary, it voted in favor of MWD's rates in 2002, and it then proposed replacing the 1998 Exchange Agreement with the 2003 Exchange Agreement based on those rates. If SDCWA truly believed in 2003 that the rates were unlawful, its silence leaves no doubt that MWD has a defense of unilateral mistake of law.

**(b) SDCWA's Evidence Does Not Show that It Believed the Rates to Be Unlawful**

So as not to lose the forest for the trees, it is a stunning position for a public agency to claim it knew a contract was unlawful, yet it proposed and voted to enter into it anyway. Public officials are not permitted to play fast and loose with the law and the welfare of their constituents. Indeed, when government officials make an illegal contract, the contract is void. *See People ex rel. Harris v. Rizzo,* 214 Cal. App. 4th 921, 941-42 (2013). Here, either SDCWA did not believe the rates were unlawful at that time or the Exchange Agreement is void.

It is uncontroverted that in 2002, SDCWA approved rates based on the rate structure for MWD's conveyances charges which included the cost allocations in the SAR, WSR and SPR that SDCWA now asserts were illegal; in 2003, SDCWA proposed and agreed to the Exchange Agreement based on a "Price" consisting of MWD's conveyance charges that SDCWA knew contained these cost allocations; SDCWA approved rates based on this same rate structure as late as 2009.

*None* of the evidence cited by SDCWA shows that SDCWA believed the rates were unlawful or expressed that belief at the time.[9] Tellingly, SDCWA does not offer any declaration or testimony from any of its representatives on the subject. MWD believes that the evidence will show that SDCWA, like any other public agency, would not have entered into a contract of this magnitude believing a core term to be unlawful, nor knowingly committed to paying an unlawfully high price, nor voted to approve rates it considered unlawful, particularly without disclosing that belief to those to whom it owed a fiduciary duty.

SDCWA has indeed complained about the SAR, but for economic reasons rather than legal ones. For example, in February 2003, Maureen Stapleton, the General Manager of SDCWA wrote to MWD complaining about the inclusion of the State Water Project costs because of "inappropriate economic signals," not because it is *unlawful*:

> [T]he Water Authority objects to the inclusion of significant water supply costs, e.g., State Water project costs, as a cost component in Metropolitan's system access rate. The inclusion of supply costs in the system access rates creates subsidies for Metropolitan supplies and increased cost for water delivery. *This result sends inappropriate economic signals on both the cost of alternative supplies and appropriate delivery costs.*

SDCWA Ex. J (emphasis added).[10]

SDCWA's outside counsel and person most knowledgeable as to the negotiation, drafting and terms of the Exchange Agreement, Scott Slater, likewise contradicts SDCWA's assertion that it believed the rates structure violated the law:

> Q. . . . So, at this point in time, in 2003, you had not identified any particular law or reg – law or regulation that Met's then-existing rate structure might be in violation of?

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[9] SDCWA's evidence does not support its claim that it conveyed the belief that MWD's rates were illegal at the time the Exchange Agreement was entered. None of the cited trial testimony states that SDCWA believed the rates were illegal. *See* SDCWA Decl. Ex. F at 219:25-220:20. SDCWA also relies on a document from 2010 – well after the Exchange Agreement was entered – and another document concerning dry-year peaking (an issue on which SDCWA did not prevail). *Id.* at 258:23-260:19. Nor do letters from the mid-1990's defeat a defense related to the rate structure that was first approved in 2001 or the parties' belief in October 2003.

[10] Furthermore, SDCWA did not complain about the other two rates in issue, it praised them. As to the SPR, Ms. Stapleton wrote: "The System Power Rate provides an excellent example of rate component transparency"; as to the WSR, she wrote: "The Water Authority supports the goal of increasing the production of recycled water and increasing support for economical water conservation programs requiring an increase in the Water Stewardship Rate." *Id.*

A. We did—we knew that there were laws that could be pertinent, but *we did not see a violation*.

Slater Deposition at 73:1-7 (emphasis added), attached to Borden Decl. as Ex. B.

SDCWA argues that the Court previously "rejected MWD's position" with respect to this testimony. However, on MWD's motion for summary adjudication of a different issue, the Court found only that this statement "says nothing more than a particular set of violations had not then been identified," and therefore did not prove that the rates "complied with the law." December 4, 2013 Order at p. 4, attached to Borden Decl. as Ex. P. The issue now is not whether the rates complied with the law, but whether SDCWA believed they were unlawful in 2003. The statement of SDCWA's person most knowledgeable that SDCWA "did not see a violation" of "pertinent" laws constitutes evidence that it did not believe at that time that the rates were unlawful.[11] *See* Slater Deposition at 73:1-7, attached to Borden Decl. as Ex. B.

SDCWA refers to the five year moratorium on litigation provided in the Exchange Agreement. Nothing in the clause suggests that the parties were promising to condone illegality for five years, a provision that would hardly be consistent with sound public policy.[12] Significantly, when the moratorium expired in 2008, SDCWA still did not assert unlawfulness or file suit for another two years. Notably, SDCWA inaccurately asserts that it was "finally free to sue in April *2010*." Opp. at 5:18-20 (emphasis added). SDCWA has not presented any explanation for its failure to make a claim in 2008 or 2009.[13]

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[11] SDCWA cites testimony from MWD's Brian Thomas as proof that SDCWA "disputed its rates." Opp. at 4:6-14. Notably, SDCWA does not claim that Mr. Thomas ever stated that SDCWA expressed that the rates were illegal, the relevant consideration for the mistake of law defense. Indeed, Mr. Thomas testified that "[d]uring the rate refinement process and cost-of-service review, San Diego staff had advocated and argued that that was a different cost allocation, never once saying it was illegal, but just that this would be a different way to allocate costs." Thomas Deposition at 147:7-12, attached to Borden Decl. as Ex. C.

[12] SDCWA states that "the contemporaneous documents make clear that . . . MWD staff generally knew San Diego likely would sue after the five-year standstill if MWD did not alter its rates." Opp. at 4:15-17. The June 29, 2004 memorandum cited by SDCWA is not a contemporaneous document since the Exchange Agreement was entered into the previous year.

[13] SDCWA cites testimony from its outside counsel as evidence that "San Diego always made clear to MWD during negotiations, and MWD always actually understood, that San Diego believed MWD's rates were unlawful . . . ." Opp. at 3:22-24. The testimony cited does not support this claim; it merely says that SDCWA might avail itself in the future of some remedy if it (footnote continued)

Thus, there is at least a question of fact as to whether one of the bases for mistake of law applies, unilateral or mutual. The issue should be determined on the evidence, not on a motion to amend.[14]

**2. MWD Can State a Defense of Illegality of Contract**

The defense of illegality of contract arises where a central aspect of the contract, or performance of such a term, is unlawful. Cal. Civ. Code § 1598; s*ee also Templeton Develop. Corp. v. Superior Court*, 144 Cal. App. 4th 1073, 1084 (2006) ("If the central purpose of the contract is tainted with illegality, then the contract as a whole cannot be enforced."); *Kashani v. Tsann Kuen China Enter. Co., Ltd.*, 118 Cal. App. 4th 531, 541-42 (2004) (a contract does not have a lawful object where illegality of the contract renders bargain unenforceable). Here, the Price – MWD's consideration – is based on rates that the Court found to be unlawful.

Illegality is determined as of the time of the formation of the contract. *See* Cal. Civ. Code §1596. When the Exchange Agreement was executed, there was an initial price of $253 per acre foot, and the rates underlying the price for 2004 had been set. Both the initial price and the price for 2004 were based on the SAR, WSR and SPR which the Court subsequently determined were unlawful. Under the Court's ruling, the Price was unlawful as of the inception of the contract and the price term could not be performed lawfully.

Furthermore, MWD's Administrative Code provides that its conveyance rates are the SAR, WSR and SPR. *See* MWD Admin. Code §§ 4123-4125 and 4401.[15] Therefore, MWD faced a legal impossibility. If it set a price consistent with what the Court has determined to be lawful, it would violate the Administrative Code. If it complied with the code, it would violate the statutes and laws the Court relied upon. MWD could not lawfully perform §5.2 of the Exchange

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believed rates were illegal. *See* Slater Deposition at 101:18-21, attached to Borden Decl. as Ex. B.

[14] SDCWA puts forward the straw man argument that if MWD claims that both parties were aware of uncertainty about the legal basis of the contract term, the mistake of law defense should be rejected. However, MWD makes no such argument.

[15] While the Exchange Agreement is not for wheeling, MWD's Administrative Code also defines its rate for wheeling service as the SAR, WSR and a power charge. *See* MWD Admin. Code § 4405.

Agreement under the Court's Statement of Decision, applying the approved rates in its Administrative Code.

SDCWA argues that the Price – MWD's consideration – is an inconsequential term of the contract. But a contract can be illegal when the consideration upon which the contract is based is illegal. *See Dunkin v. Boskey*, 82 Cal. App. 4th 171, 183 (2000) (a contract may be illegal either in its apparent substance and purpose or "in the consideration upon which it is based."); *Kallen v. Delug*, 157 Cal. App. 3d 940, 949 (1984) (same); s*ee also McGillycuddy v. Los Verjels Land & Water Co.*, 213 Cal. 145, 146-47 (1931) (performance of services was legal but payment of the specified compensation was illegal).[16]

SDCWA relies largely on a presumption that if a contract can be performed legally, a court will find that the parties intended a lawful performance. But the presumption does not apply where the party seeking to enforce the contract intended an illegal performance. *Burger v. Kuimelis*, 325 F. Supp. 2d 1026, 1039 (N.D. Cal. 2004), *citing Redke v. Silvertrust*, 6 Cal. 3d 94, 103-04 (1971) and *Tri–Q, Inc. v. Sta–Hi Corp.*, 63 Cal. 2d 199, 219 (1965). Here, SDCWA admits, indeed it argues as a fact in its favor, that it intended that the parties perform illegally, *i.e.* to charge and pay a price that SDCWA believed to be unlawful. Therefore, the presumption on which SDCWA relies does not apply. Instead, the Court should apply the general rule that courts will not enforce illegal contracts so as "to promote a societal recognition that certain types of transactions should be discouraged." *Dunkin*, 82 Cal. App. 4th at 183, *citing Moran v. Harris* (1982) 131 Cal. App. 3d 913, 918. MWD believes that parties should be discouraged from proposing and entering into contracts when they believe a material term is unlawful without disclosing that belief.[17]

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[16] SDCWA also argues that the "only" illegality is MWD's "failure to perform" the price term and that the Court found "that MWD had breached that term by charging unlawful rates." But, in fact, the Court found that the rates which make up the Price are illegal and has yet to rule on breach of contract. SDCWA cannot have it both ways. If the rates were unlawful for purposes of breach of contract, the rates were unlawful for the affirmative defenses as well.

[17] SDCWA does not even address other aspects of illegality, such as gift of public funds. SDCWA contends it knowingly agreed to and did overpay public funds. Cal. Const., Art. XVI, Sec. 6; s*ee*, *e.g.*, *County of Riverside v. Idyllwild County Water Dist.*, 84 Cal. App. 3d 655, 660 (footnote continued)

**3. SDCWA Has Not Shown Prejudice**

SDCWA has failed to show any prejudice if leave to amend is granted. It does not express any surprise, claim any need for discovery or assert any other prejudice. SDCWA does state that allowing the defenses will delay the trial. But SDCWA does not explain how it would delay the trial. Again, SDCWA seeks no new discovery and, in fact, claims it already has the evidence it needs. It is generally an "abuse of discretion to deny leave to amend where the opposing party was not misled or prejudiced." *Kittredge,* 213 Cal. App. 3d at 1048.

**4. MWD Did Not Delay Seeking Leave to Amend**

After the Court issued the Statement of Decision on April 24, 2014, MWD analyzed the implications of the Court's findings. Based on the Court's particular findings and the bases for those findings, MWD determined that the defenses of mistake of law and illegality of contract were supported by the Statement of Decision. Shortly thereafter, MWD filed the instant motion. There was no unreasonable delay and, again, no prejudice from any delay. Furthermore, the defense of illegality of contract is so fundamental that it may be raised by a party at any time. *Fellom v. Adams*, 274 Cal. App. 2d 855, 863 (1969).[18]

**5. Leave to Amend the Answers Will Promote Consistency Among the 2010, 2012 and 2014 Actions**

SDCWA has no response to MWD's showing that there would be a risk of inconsistent and conflicting judgments among the 2010, 2012 and 2014 Actions if leave to amend were to be denied. *See Lockwood v. Superior Court*, 160 Cal. App. 3d 667 (1984) (inconsistent judgments "undermine the integrity of the judicial system"). MWD now has asserted the defenses of mistake of law and illegality of contract in the 2014 Action (SDCWA pled the same cause of action for breach of the Exchange Agreement that it pled in the 2010 and 2012 Actions other than as to the

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(1978) (county's agreement to pay an invalid charge would amount to a gift of public funds, violating Art. XVI, Sec. 6).

[18] SDCWA relies on *Melican v. Regents of Univ. of California*, 151 Cal. App. 4th 168, 175 (2007). But in *Melican,* the plaintiff moved to amend the complaint to add a new contract claim after five years of litigation with *no* explanation of the delay.

time period for which it seeks damages). MWD should be permitted to assert the same defenses in all three actions, particularly in the absence of prejudice.

**Conclusion**

Metropolitan does not seek to delay or unnecessarily complicate the resolution of these actions. SDCWA jumped the gun on its breach of contract action by combining it with a writ proceeding challenging rates. Until the rate challenge has run its course, SDCWA cannot show damage. The proper sequence would have been to first file a writ proceeding which would have resulted in directions for proper rate setting. Only when the rates have been re-set could SDCWA know whether, and by how much, it had been damaged; that is, the amount it paid above what it would have paid under lawful rates.

The way forward now is either to dismiss the contract action until it is ripe or impose on the Court a task that even SDCWA has characterized as foolish: set rates. If the Court tries the breach of contract claim, justice requires a full and fair opportunity to present all the claims and defenses and the relevant evidence on the merits, including expert testimony. The distribution of water to nearly 19 million residents in Southern California depends on it.

Therefore, MWD respectfully requests that the Court grant its motions in their entirety.

DATED: July 30, 2014

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