CONTRACTS II (§§ 112 – A & C)

SUPPLEMENTAL CASE MATERIALS

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WESTERN STATE UNIVERSITY COLLEGE OF LAW
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TABLE OF CONTENTS

Cases Compiled & Edited by Kevin Mohr
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***Pershing Park Villas Homeowners Ass'n v. United Pacific Ins. Co.*, 219 F.3d 895 (9th Cir. 2000).**

United States Court of Appeals,
Ninth Circuit.

PERSHING PARK VILLAS HOMEOWNERS ASSOCIATION, an unincorporated and non-profit Homeowners Association; CSP-Pershing, Ltd., a California Limited Partnership; Harry Bigham; Timothy Penkala; and Joseph John, Plaintiffs-Appellees,
v.
UNITED PACIFIC INSURANCE COMPANY, a Washington corporation; and Reliance Insurance Co., Defendants-Appellants.

No. 98-56261

Argued and Submitted Feb. 10, 2000
Filed July 10, 2000
As Amended Aug. 11, 2000

***897** Appeal from the United States District Court for the Southern District of California; Edward J. Schwartz, District Judge, Presiding. D.C. No. CV-95- 01918-S.

Before: BOOCHEVER, HAWKINS, and THOMAS, Circuit Judges.

BOOCHEVER, Circuit Judge:

Reliance Insurance Company appeals a judgment entered on a multimillion- dollar jury verdict. The jury found that Reliance acted in bad faith when it withdrew its defense of insured real estate developers in a construction-defect suit brought by a homeowners' association, and refused to pay the resulting default judgment. We reverse the judgment inasmuch * * * as it did not award the amount of the default judgment to the insured developers as damages for Reliance's bad-faith failure to defend. We affirm the judgment in all other respects.

***898 I**

The **Pershing Park** Villas Homeowners Association brought suit against real estate **developers** Harry Bigham, Timothy Penkala, and Joseph John, alleging defects and property damage in the construction of a twelve-unit condominium. The developers tendered the defense of the suit to their property damage insurer, **United Pacific** Insurance Company. United Pacific's parent, **Reliance** Insurance Company, assumed the defense under a reservation of rights. Approximately four months before trial, Reliance withdrew its defense on the ground that the damage in question was not covered under the policy. Though Reliance had obtained a legal opinion from outside counsel to this effect, it did not obtain a declaration of noncoverage from the court.

The developers did not retain new counsel to defend the suit, and the homeowners obtained a default judgment against them for $339,000. Reliance refused to pay the judgment. Faced with the unsatisfied judgment and other debts, the developers petitioned for bankruptcy protection. The developers did not list any unliquidated bad faith claims against Reliance among the assets disclosed in their bankruptcy schedules. Though it appears that at least one of the developers may have referred to claims against an insurance company in later correspondence with his bankruptcy trustee, the developers' trustees never expressly abandoned any prebankruptcy claims against Reliance.

Nevertheless, the developers, joined by the homeowners, brought this suit against Reliance for breach of contract, bad faith, and a variety of other torts arising out of Reliance's failure to defend or indemnify the developers. [FN1] The developers sought the amount of the default judgment, plus consequential damages for emotional distress and for loss of prospective economic advantage. Specifically, the developers claimed that the default judgment had pushed them into bankruptcy, and that as a result they had been unable to obtain credit to participate in the lucrative San Diego repossessed real estate market of the mid 1990s. Concomitant to this financial distress, they claimed to have endured severe depression and anxiety.

* * * Prior to trial, the district court granted the plaintiffs' motion for partial summary judgment against Reliance for breach of its duty to defend the developers, * * * citing internal Reliance documents showing that Reliance knew there was a potential for coverage at the time it withdrew the defense, and cases holding that an insurer is

liable for a judgment even on a noncovered claim when it fails to defend in bad faith.

The district court granted the motion for summary judgment and found that Reliance was liable for the entire default judgment as a consequence of its failure to defend the developers, [which failure it found] was wrongful as a matter of law. * * *

***899** Notwithstanding its finding that Reliance acted in bad faith as a matter of law, the district court submitted to the jury the issue of whether Reliance's conduct breached the covenant of good faith and fair dealing. After a lengthy trial and brief deliberations, the jury found that Reliance had breached a duty of good faith and fair dealing as to both the developers and the homeowners, and awarded damages totaling $27 million. On Reliance's motion for a new trial, the plaintiffs agreed to remit all but approximately $5 million of the jury's award.

Under the reduced award, the homeowners received $175,000 for breach of the covenant of good faith and fair dealing, in addition to the amount of the default judgment that had been awarded to them in the construction-defect suit. The developers received $1,400,000 each for economic losses caused by Reliance's bad faith and negligence, and $200,000 each for emotional distress. Unsatisfied with the remittitur, Reliance appeals on numerous grounds.

II

[*Part II, which addresses a procedural issue, has been redacted.*]

***901** III

We turn to Reliance's liability for its withdrawal of their defense. Reliance argues that the district court erred in holding that Reliance's bad faith rendered it automatically liable without any showing that the default judgment in the construction-defect suit would not have been entered but for Reliance's wrongful conduct.

A

The general rule is long-settled in California that "an insurer that wrongfully refuses to defend is liable on the judgment against the insured." <u>Gray v. Zurich Ins. Co.</u>, 65 Cal.2d 263, 54 Cal.Rptr. 104, 419 P.2d 168, 179 (Cal.1966); <u>Amato v. Mercury Cas. Co.</u>, 53 Cal.App.4th 825, 61 Cal.Rptr.2d 909, 914 (Ct.App.1997). The duty to defend is broader than the duty to indemnify, and extends to claims that are merely potentially covered. <u>Montrose Chem. Corp. v. Superior Ct.</u>, 6 Cal.4th 287, 24 Cal.Rptr.2d 467, 861 P.2d 1153, 1157 (Cal.1993). Where the wrongful refusal to defend is also unreasonable, it violates the covenant of good faith and fair dealing, and the insurer will be liable for consequential damages regardless of foreseeability. <u>Amato</u>, 61 Cal.Rptr.2d at 915; <u>Campbell v. Superior Ct.</u>, 44 Cal.App.4th 1308, 52 Cal.Rptr.2d 385, 392-93 (Ct.App.1996).

It is no defense that the ultimate judgment against the insured is not necessarily rendered on a theory within the coverage of the policy. See <u>Gray</u>, 54 Cal.Rptr. 104, 419 P.2d at 179; <u>Amato</u>, 61 Cal.Rptr.2d at 914. [FN4] Nor must the insured ***902** prove that the judgment would have been smaller, or would not have occurred, but for the insurer's wrongful failure to defend: "Such a theory ... would impose upon the insured the impossible burden of proving the extent of the loss caused by the insurer's breach." <u>Gray</u>, 54 Cal.Rptr. 104, 419 P.2d at 179 (quotations omitted).

> FN4. An insurer may, however, raise the defense of noncoverage when it was not possible that the judgment was rendered on a covered theory, as when issues relating to the asserted defense of noncoverage were not raised in the underlying suit, or when the judgment was expressly rendered on a theory of liability outside the policy. See <u>Hogan v. Midland Ins. Co.</u>, 3 Cal.3d 553, 91 Cal.Rptr. 153, 476 P.2d 825, 832-33 (Cal 1970); <u>Pruyn v. Agricultural Ins. Co.</u>, 36 Cal.App.4th 500, 42 Cal.Rptr.2d 295, 302 n. 15 (Ct.App.1995).

The <u>Gray</u> rule of automatic liability applies equally to judgments entered by default. "When the insurer refuses to defend and the insured does not employ counsel and presents no defense, it can be said the ensuing default judgment is proximately caused by the insurer's breach of the duty to defend." <u>Amato</u>, 61 Cal.Rptr.2d at 915.

Reliance argues that <u>Amato</u> was wrongly decided on this point, and that the California Supreme Court would instead apply the rule in <u>Travelers Ins. Co. v. Lesher</u>, 187 Cal.App.3d 169, 231 Cal.Rptr. 791 (Ct.App.1986). In Lesher, the plaintiff contended that he would have prevailed at trial but for the failure of his insurer to conduct his defense with due care. Analogizing the claim to one for professional malpractice, the court required the plaintiff to prove the extent to which the judgment resulted from the insurer's negligent defense, and not from the underlying merits of the case. See id. at 805.

The rule in Lesher derives from the prima facie element of professional negligence that requires a plaintiff to prove the extent of "actual loss or damage resulting from the professional's negligence." Mattco Forge, Inc. v. Arthur Young & Co., 52 Cal.App.4th 820, 60 Cal.Rptr.2d 780, 788 (Ct.App.1997). The tort of bad faith is not predicated on negligence, and for this reason subsequent courts of appeal have held the Lesher "trial-within-a-trial" rule inapplicable where the judgment against the insured has resulted not "upon negligent malpractice of a defense actually undertaken," but on the bad faith failure to provide any defense at all. Amato, 61 Cal.Rptr.2d at 917.

The distinction is a reasonable one. The insured is relieved of proving the extent of damages in a bad faith action in order to remove the insurer's incentive to strategically disavow responsibility for the insured's defense "with everything to gain and nothing to lose." Gray, 54 Cal.Rptr. 104, 419 P.2d at 179 (quotations omitted). By contrast, an insurer that actually undertakes a defense has no similarly powerful strategic incentive to conduct the defense negligently.

Reliance does not dispute the jury's well-supported conclusion that it breached the covenant of good faith and fair dealing when it wrongfully withdrew the developers' defense. Reliance is therefore liable to the developers for the amount of the judgment, and all other damages consequential to it.

B

[*Part III.B., addressing the homeowner's recovery, has been redacted. The court held the homeowners could not recover against the insurer.*]

***903** IV

Reliance challenges the jury's award of damages to compensate the developers for emotional distress. Reliance argues that California law, which governs this diversity action, permits the developers to recover only for emotional distress that was severe, substantial, and enduring. Reliance also challenges the size of the emotional distress awards.

A

Though emotional distress must be severe to be actionable by itself, no heightened showing is required to obtain damages for mental suffering that naturally ensues from the commission of a distinct and independent tort. See Gruenberg v. Aetna Ins. Co., 9 Cal.3d 566, 108 Cal.Rptr. 480, 510 P.2d 1032, 1041-42 (Cal.1973). The requirement of severity is designed to address " 'the fear of fictitious or trivial claims, distrust of the proof offered, and the difficulty of setting up any satisfactory boundaries to liability' " when no injury other than emotional distress is alleged. Id. (quoting Restatement (Second) of Torts § 46 cmt. b (1965)). These concerns are mitigated when "substantial damages for loss of property" corroborate the plaintiff's mental suffering. A plaintiff may therefore recover damages for nonsevere emotional distress ensuing from tortious conduct that also results in significant economic loss. Id. at 1041-42. * * *

The California Supreme Court reiterated its Gruenberg holding in Gourley v. State Farm Mutual Automobile Insurance Co., 53 Cal.3d 121, 3 Cal.Rptr.2d 666, 822 P.2d 374 (Cal.1991). In the course of drawing distinctions between the types of damages available in bad-faith and personal-injury suits, the court noted:

> ***904** We observed [in Gruenberg] that damages for emotional distress are compensable as incidental damages flowing from the initial breach, not as a separate cause of action: "[Because] we are concerned with mental distress resulting from a substantial invasion of property interests of the insured and not with the independent tort of intentional infliction of emotional distress, we deem [the requirements of outrageous conduct and severe emotional distress] to be inapplicable." Thus, once the threshold requirement of economic loss is met, the insured need not show additional loss or injury to recover damages for his mental distress as long as such damages were proximately caused by his insurer's breach of the implied covenant.

Id. at 378 (citation omitted) (quotation altered in original) (quoting Gruenberg, 108 Cal.Rptr. 480, 510 P.2d at 1032). The California Supreme Court also recently cited Gruenberg in Cates Construction, Inc. v. Talbot Partners, 21 Cal.4th 28, 86 Cal.Rptr.2d 855, 980 P.2d 407, 416 (Cal.1999), for the proposition that "[i]n the insurance policy setting, an insured may recover damages not otherwise available in a contract action, such as emotional distress damages resulting from the insurer's bad faith conduct."

The California Supreme Court recently denied review in a case where the application of the Gruenberg rule was decisive. In Clayton v. United Services Automobile Association, 54 Cal.App.4th 1158, 63 Cal.Rptr.2d 419 (Ct.App.1997), rev. denied, an insured was awarded damages for economic loss and for emotional distress caused by his insurer's bad faith denial of a claim. The insurer argued "that the jury should have been instructed that, in order to be compensable the emotional distress suffered must have been severe, substantial or enduring...." Id. at 421 (quotations omitted). Citing Gruenberg, the court rejoined "our Supreme Court has rejected any such a requirement." Id.

California authority subsequent to Gilchrest clearly holds that a plaintiff may recover damages for all emotional distress incident to an insurer's bad faith denial of coverage, so long as the insurer's conduct also resulted in substantial financial loss. There was evidence that the developers suffered substantial financial loss, and they are therefore entitled to recover for the variety of emotional symptoms, including major depression, that resulted from their bankruptcies.

B

Reliance argues that the emotional distress awards are excessive in amount under Merlo v. Standard Life & Accident Insurance Co., 59 Cal.App.3d 5, 130 Cal.Rptr. 416 (Ct.App.1976). In Merlo, a California appeals court found an award of $250,000 for mental anguish excessive in proportion to the plaintiff's financial injury of $7,500. Id. at 423-24. Merlo's rule of proportionality does not come into play here, where damages for emotional distress amount to a small fraction of the damages awarded for financial injury. Reliance appears to argue that the developers here should receive substantially less in absolute compensation than the amount deemed excessive in Merlo, because the developers suffered less than the Merlo plaintiff. This reasoning is unsupported by precedent, ignores the effect of inflation, and appears to be nothing more than an invitation to reweigh the evidence on appeal.

PARTS V & VI OF THE OPINION HAVE BEEN REDACTED

***905** VII

We [affirm] the judgment of the district court. Each party shall bear its own costs on appeal.

United States v. Seacoast Gas Co., Inc., 204 F.2d 709 (5th Cir. 1953).

United States Court of Appeals Fifth Circuit.

United States
v.
Seacoast Gas Co., Inc. et al.

No. 14314.
May 29, 1953.
Rehearing Denied July 20, 1953.

Suit against gas company and its surety on gas company's performance bond, for damages alleged to have resulted from an anticipatory breach of contract in nature of notice of intent to cancel contract as of November 15, 1947. The United States District Court for the Southern District of Georgia entered judgment in favor of gas company and surety, and plaintiff appealed.

Judgment reversed, cause remanded with directions.

***709 Opinion**

HUTCHESON, Chief Judge.

Brought against Seacoast Gas Company and the surety on it performance bond, the suit was for damages alleged to have resulted from the anticipatory breach by the Gas Company of its contract with plaintiff to supply gas to a federal housing project during the period from April 15, 1947, to June 15, 1948. The claim was: that on October 7, 1947, while performances of the contract was in progress, Seacoast anticipatorily ***710** breached the contract by writing plaintiff unequivocally that, because of plaintiff's breach of the contract, Seacoast intended to cancel same as of November 15, 1947; that the plaintiff immediately notified Seacoast that it did not recognize any right in it to cease performance and that it proposed to advertise for bids to insure a continued supply of gas if Seacoast's breach persisted; that, thereafter, having advertised for bids and on November 6th, having received the low bid from Trion Company, it on that date notified Seacoast by letter[1] that unless it retracted its repudiation of the contract within three days from the letter date, Trion's bid would be accepted and Seacoast and its surety would be held liable for breach of contract; and that thereafter Seacoast not having retracted within the time fixed, plaintiff on November 10, accepted Trion's bid and, pursuant thereto, began its preparations to execute with Trion a contract for a price in excess of that provided in the Seacoast contract, and Seacoast is liable to plaintiff for this excess.

1 The text of this letter stated:

> ‘As you already are advised, since Mr. Carley Zell was present at the opening of bids, the Government has advertised for bids for supplying all liquified petroleum gas requirements for War Housing Project, VA-44067 at Newport News, Virginia for the period from November 15, 1947, to June 15, 1948. This was made necessary by your notice that you were cancelling your contract for supplying liquified petroleum gas to this project as of November 15, 1947, and would not perform after that date.Two bids were received pursuant to the advertising hereinbefore mentioned. They are as follows:Modern Fuel and Service Corporation 16.31¢ per therm Charlotte, North CarolinaTrion Gas Service, Incorporated 15.75¢ per therm Brunswick, GeorgiaThis is to notify you that unless we receive from you a written withdrawal of your cancellation notice and assurance of continued performance under your contract to furnish the liquified petroleum gas requirements for War Housing Project VA-44067, Newport News, Virginia, within three days from the date of this notice, we shall proceed to accept the bid of the Trion Gas Service, Incorporated, the low bidder, and hold you and your performance bond obligated for your breach of performance of your contract.'

Defendant Seacoast, admitting in its pleading and its testimony that the facts were substantially as claimed by plaintiff, defended on the ground: that it had retracted its notice of repudiation and given assurance of its intention to continue to perform before the plaintiff had actually signed the new contract; and that, since, as it claimed, plaintiff had not then substantially changed its position or suffered any damages as a result of Seacoast's notice to terminate the contract and cease performance under it, the retraction was timely and healed the breach.

Upon the issue thus joined, the cause was tried to the court without a jury, and the court stating the question for decision thus, ‘The question in this case is as to whether Seacoast Gas Company, Inc. withdrew its notice of cancellation of its contract prior to the rendering of the contract to the Trion Gas Company, found that it had done so. On the basis of this finding and a further finding that on November 13, two days before the termination date which Seacoast had fixed in its notice, Zell, who was president both of Seacoast and of Trion Company, to whom the new contract was awarded, notified the regional counsel for the Public Housing Authority that Seacoast admitted it had no right to cancel the contract and was rescinding its notice, the court held that the anticipatory breach had been healed and plaintiff could not recover.

Appealing from this judgment, plaintiff is here insisting that under the settled law governing anticipatory breaches not only as it is laid down in Georgia but generally, Seacoast's retraction came too late to heal the breach, and the judgment must be reversed.

Appellees, on their part, insist that the judgment appealed from was soundly based in law and in fact and must be affirmed.

We do not think so. The undisputed facts establish: that Zell, president of both companies, was present at the opening of the new bids on November 6, 1947, and ***711** upon being asked to withdraw Seacoast's notice that it would cease performing the contract, refused to do so; that on that date the Public Housing Administration regional counsel wrote Seacoast by registered mail, addressed ‘Attention Zell’, advising of the steps the government had taken and stating that unless Seacoast retracted its repudiation within three days from the date of the letter, Trion's bid would be accepted and Seacoast and its sureties would be held liable for breach of contract; and that having received no response from Seacoast within the three days specified, and Zell again asked on November 10th, to retract the notice of repudiation having refused to do so, the government accepted Trion's bid and proceeded with the execution of the contract. The record standing thus, under settled law not only of Georgia but generally elsewhere, the breach was not healed, the judgment was wrong, and it must be reversed.

A comparison of the briefs and arguments of appellant and appellees will show that the case is in quite small compass. Both agree that Seacoast's letter of October 24th operated as an anticpatory breach and that unless effectively withdrawn during the locus poenitentiae it operated to put Seacoast in default and to render it liable for the loss to the government of the difference in price between the old and the new contract.

Appellees, after quoting from Anson on Contracts, 6th Ed. Sec. 385, p. 444:

> ‘The repudiator has the power of retraction prior to any change of position by the other party, but not afterwards.’

go on to say:

> ‘So we see that the authorities seem to be unanimous that a person who gives notice of his intention not to perform a contract may withdraw such notice and offer to perform prior to the time the other party acted or relied thereon.’

Based upon these premises, they insist that ‘the undisputed evidence is that appellant did not ‘accept the bid of Trion Gas' until November 17th, which was after the notice of cancellation had been withdrawn in writing.’

We think: that this statement is erroneous; that it represents the crucial difference between the parties; and that the error of the statement lies in the fact that it confuses the acceptance of the bid with the signing of the contract.

It is true that the contract was not signed until the 17th, after Seacoast had retracted its notice and if appellees were correct in its position that the date of the signing of the new contract was determinative of this case, they would be correct in their conclusion that the judgment should be affirmed.

But that position is not correct. In fact and in law, when the government took bids and notified Seacoast that unless it retracted with three days it would proceed to accept the Trion bid and award the contract to it, the locus poenitentiae ended with these three days. The fact that Seacoast claims that it did not receive the notice is completely immaterial both because it was not necessary for the government to give any notice or fix any time and because Zell, on November 10th, repeated to the Regional Counsel his refusal to retract.

All that is required to close the door to repentance is definite action indicating that the anticipatory breach has been accepted as final, and this requisite can be supplied either by the filing of a suit or a firm declaration, as here, that unless within a fixed time the breach is repudiated, it will be accepted.

***712** Here, in addition to this firm declaration, the record shows the taking of bids and the awarding of the contract to the lowest bidder. The error of the district judge lies, we think, in holding that the locus poenitentiae was extended until the 17th, when the contract was signed, and that Seacoast having repented before the signing of the contract, had healed the breach and restored the contract to its original vitality.

Whatever of doubt there may be, and we have none with respect to this view, as a matter of strict law, there can be none with respect to the justice or equity of this determination when it is considered; that Zell, the president and practically sole owner of Seacoast, was the organizer, the president and practically sole owner of Trion; that he organized Trion for the sole purpose of the bidding; and that on the date the bids were opened and later on the date the contract was awarded, he, though requested to do so, refused to withdraw Seacoast's repudiation and continued in that refusal until a day or two before the contract was signed.

The evidence showing, as it does, without contradiction, that the signing of the contract was not delayed because of a purpose on the part of the government to extend the time for Seacoast's repentance, but because until that date Trion had not furnished his bond, we think it clear that, in entering judgment for the defendants, the court erred. The judgment is, therefore, reversed and the cause is remanded with directions to enter judgment for plaintiff for the loss Seacoast's breach of contract has caused it.

Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association, 55 Cal.4th 1169, 151 Cal. Rptr. 3d 93, 291 P.3d 316 (2013).

Supreme Court of California

RIVERISLAND COLD STORAGE, INC., et al., Plaintiffs and Appellants,
v.
FRESNO–MADERA PRODUCTION CREDIT ASSOCIATION, Defendant and Respondent.

No. S190581.
Jan. 14, 2013.

***1170 **316 Opinion**

CORRIGAN, J.

***1171 **317** The parol evidence rule protects the integrity of written contracts by making their terms the exclusive evidence of the parties' ***1172** agreement. However, an established exception to the rule allows a party to present extrinsic evidence to show that the agreement was tainted by fraud. Here, we consider the scope of the fraud exception to the parol evidence rule.

As we discuss below, the fraud exception is a longstanding one, and is usually stated in broad terms. However, in 1935 this court adopted a limitation on the fraud exception: evidence offered to prove fraud "must tend to establish some independent fact or representation, some fraud in the procurement of the instrument or some breach of confidence concerning its use, and not a promise directly at variance with the promise of the writing." (*Bank of America etc. Assn. v. Pendergrass* (1935) 4 Cal.2d 258, 263, 48 P.2d 659 (*Pendergrass*).) The *Pendergrass* rule has been criticized but followed by California courts, for the most part, though some have narrowly construed it. The Court of Appeal in this case adopted such a narrow construction, deciding that evidence of an alleged oral misrepresentation of the written terms themselves is not barred by the *Pendergrass* rule.

Plaintiffs, who prevailed below, not only defend the Court of Appeal's holding but, alternatively, invite us to reconsider *Pendergrass.* There are good reasons for doing so. The *Pendergrass* limitation finds no support in the language of the statute codifying the parol evidence rule and the exception for evidence of fraud. It is difficult to apply. It conflicts with the doctrine of the Restatements, most treatises, and the majority of our sister-state jurisdictions. Furthermore, while intended to prevent fraud, the rule established in *Pendergrass* may actually provide a shield for fraudulent conduct. Finally, *Pendergrass* departed from established California law at the time it was decided, and neither acknowledged nor justified the abrogation. *****95** We now conclude that *Pendergrass* was ill-considered, and should be overruled.

I. BACKGROUND

Plaintiffs Lance and Pamela Workman fell behind on their loan payments to defendant Fresno–Madera Production Credit Association (Credit Association or Association). They restructured their debt in a written agreement, dated March 26, 2007, which confirmed outstanding loans with a total delinquency of $776, 380.24. In the new agreement, the Credit Association promised it would take no enforcement action until July 1, 2007, if the Workmans made specified ***1173** payments. As additional collateral, the Workmans pledged eight separate parcels of real property. They initialed pages bearing the legal descriptions of these parcels.

****318** The Workmans did not make the required payments. On March 21, 2008, the Credit Association recorded a notice of default. Eventually, the Workmans repaid the loan and the Association dismissed its foreclosure proceedings. The Workmans then filed this action, seeking damages for fraud and negligent misrepresentation, and including causes of action for rescission and reformation of the restructuring agreement. They alleged that the Association's vice president, David Ylarregui, met with them two weeks before the agreement was signed, and told them the Association would extend the loan for two years in exchange for additional collateral consisting of two ranches. The Workmans further claimed that when they signed the agreement Ylarregui assured them its term was two years and the ranches were the only additional security. As noted, the contract actually contemplated only three months of forbearance by the Association, and identified eight parcels as additional collateral. The Workmans did not read the agreement, but simply signed it at the locations tabbed for signature.

The Credit Association moved for summary judgment. It contended the Workmans could not prove their claims because the parol evidence rule barred evidence of any representations contradicting the terms of the written agreement. In opposition, the Workmans argued that Ylarregui's misrepresentations were admissible under the fraud exception to the parol evidence rule. Relying on *Pendergrass, supra,* 4 Cal.2d 258, 48 P.2d 659, the trial court granted summary judgment, ruling that the fraud exception does not allow parol evidence of promises at odds with the terms of the written agreement.

The Court of Appeal reversed. It reasoned that *Pendergrass* is limited to cases of promissory fraud.[3] The court considered false statements about the contents of the agreement itself to be factual misrepresentations beyond the scope of the *Pendergrass* ******96*** rule. We granted the Credit Association's petition for review.

3 One of the forms of "[a]ctual fraud" is "[a] promise made without any intention of performing it." (Civ.Code, § 1572, subd. 4.)

*1174 II. DISCUSSION

A. *The Parol Evidence Rule and the* Pendergrass *Limitation*

The parol evidence rule is codified in Code of Civil Procedure section 1856 and Civil Code section 1625. It provides that when parties enter an integrated written agreement, extrinsic evidence may not be relied upon to alter or add to the terms of the writing.[4] (*Casa Herrera, Inc. v. Beydoun* (2004) 32 Cal.4th 336, 343, 9 Cal.Rptr.3d 97, 83 P.3d 497 (*Casa Herrera*).) "An integrated agreement is a writing or writings constituting a final expression of one or more terms of an agreement." (Rest.2d Contracts, § 209, subd. (1).)

There is no dispute in this case that the parties' agreement was integrated.

4 Code of Civil Procedure section 1856, subdivision (a) states: "Terms set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement." * * *

Although the parol evidence rule results in the exclusion of evidence, it is not a rule of evidence but one of substantive law. It is founded on the principle that when the parties put all the terms of their agreement in writing, the ****319** writing itself becomes the agreement. The written terms supersede statements made during the negotiations. Extrinsic evidence of the agreement's terms is thus *irrelevant,* and cannot be relied upon. "[T]he parol evidence rule, unlike the statute of frauds, does not merely serve an evidentiary purpose; it determines the enforceable and incontrovertible terms of an integrated written agreement." (Casa Herrera, Id. at p. 345, 9 Cal.Rptr.3d 97, 83 P.3d 497.) The purpose of the rule is to ensure that the parties' final understanding, deliberately expressed in writing, is not subject to change.

Section 1856, subdivision (f) establishes a broad exception to the operation of the parol evidence rule: "Where the validity of the agreement is the fact in dispute, this section does not exclude evidence relevant to that issue." This provision rests on the principle that the parol evidence rule, intended to protect the *terms* of a valid written contract, should not bar evidence challenging the *validity* of the agreement itself. "Evidence to prove ***1175** that the instrument is void or voidable for mistake, fraud, duress, undue influence, illegality, alteration, lack of consideration, or another invalidating cause is admissible. This evidence does not contradict the terms of an effective integration, because it shows that the purported instrument has no legal effect." The fraud exception is expressly stated in section 1856, subdivision (g): "This section *****97** does not exclude other evidence ... to establish ... fraud."

Despite the unqualified language of section 1856, which broadly permits evidence relevant to the validity of an agreement and specifically allows evidence of fraud, the *Pendergrass* court decided to impose a limitation on the fraud exception.[5] The facts of *Pendergrass* are similar in certain respects to those here. Borrowers fell behind on their payments. They and the bank executed a new promissory note, which was secured by additional collateral and payable on demand. Soon after it was signed, the bank seized the encumbered property and sued to enforce the note. In defense, the borrowers claimed the bank had promised not to interfere with their farming operations for the remainder of the year, and to take the proceeds of those operations in payment. They alleged that the bank had no intention of performing these promises, but made them for the fraudulent purpose of obtaining the new note and additional collateral.

The *Pendergrass* court * * * considered whether oral testimony would be admissible to establish the lender's alleged promise not to require payment until the borrowers sold their crops. “This promise is in direct contravention of the unconditional promise contained in the note to pay the money on demand.”

The court stated: “Our conception of the rule which permits parol evidence of fraud to establish the invalidity of the instrument is that it must tend to establish some independent fact or representation, some *fraud in the procurement of the instrument or some breach of confidence concerning its use*, and not a promise directly at variance with the promise of the writing. We find apt ***1176** language in *Towner v. Lucas' Exr.* [(1857)] 54 Va. (13 Gratt.) 705, 716, in ****320** which to express our conviction: ‘It is reasoning in a circle, to argue that fraud is made out, when it is shown by oral testimony that the obligee contemporaneously with the execution of a bond, promised not to enforce it. Such a principle would nullify the [parol evidence] rule: for conceding that such an agreement is proved, or any other contradicting the written instrument, the party seeking to enforce the written agreement according to its terms, would always be guilty of fraud. The true question is, Was there any such agreement? And this can only be established by legitimate testimony. For reasons founded in wisdom and to prevent frauds and perjuries, the rule of the common law excludes such oral testimony of the alleged oral agreement; and as it cannot be proved by legal evidence, the oral agreement itself in legal contemplation, cannot be regarded as existing in fact.’” (*Pendergrass, supra,* 4 Cal.2d at pp. 263–264, 48 P.2d 659.) (Emphasis added.)

B. *Reactions to* Pendergrass

Despite some criticism, *Pendergrass* has survived for over 75 years and the Courts *****98** of Appeal have followed it, albeit with varying degrees of fidelity. (See Sweet, *Promissory Fraud and the Parol Evidence Rule* (1961) 49 Cal. L.Rev. 877 (Sweet).) Until now, this court has not revisited the *Pendergrass* rule.

The primary ground of attack on *Pendergrass* has been that it is inconsistent with the principle, reflected in the terms of section 1856, that a contract may be invalidated by a showing of fraud. See *Pacific State Bank v. Greene* (2003) 110 Cal.App.4th 375, 390, 392, 1 Cal.Rptr.3d 739.) Evidence is deemed admissible for the purpose of proving fraud, without restriction, in the Restatements. (Rest.2d Contracts, § 214, subd. (d),; Rest.2d Torts, § 530.) Most of the treatises agree that evidence of fraud is not affected by the parol evidence rule. The majority of other jurisdictions follow this traditional view. ***1177** See Sweet, *supra,* 49 Cal. L.Rev. at p. 889.)

Underlying the objection that *Pendergrass* overlooks the impact of fraud on the validity of an agreement is a more practical concern: its limitation on evidence of fraud may itself further fraudulent practices. As an Oregon court noted: “Oral promises made without the promissor's intention that they will be performed could be an effective means of deception if evidence of those fraudulent promises were never admissible merely because they were at variance with a subsequent written agreement.” (*Howell v. Oregonian Publishing Co.* (1987) 85 Or.App. 84, 735 P.2d 659, 661.) Corbin observes: “The best reason for allowing fraud and similar undermining factors to be proven extrinsically is the obvious one: if there was fraud, or a mistake or some form of illegality, it is unlikely that it was bargained over or will be recited in the document. To bar extrinsic evidence would be to make the parol evidence rule a shield to ****321** protect misconduct or mistake.” (6 Corbin on Contracts, *supra,* § 25.20[A].)

Pendergrass has been criticized on other grounds as well. The distinction between promises deemed consistent with the writing and those considered inconsistent has *****99** been described as “tenuous.” (*Coast Bank v. Holmes* (1971) 19 Cal.App.3d 581, 591, 97 Cal.Rptr. 30.) The distinction between false promises and misrepresentations of fact has been called “very troublesome.” (Sweet, *supra,* 49 Cal. L.Rev. at p. 895.) It has also been noted that some courts have resisted applying the *Pendergrass* limitation by various means, leading to uncertainty in the case law. (Sweet, *supra,* 49 Cal. L.Rev. at pp. 885–886; *id.* at p. 907.)[7]

7 * * * The most well-developed detour around *Pendergrass* has drawn a line between false *promises* at variance with the terms of a contract and misrepresentations of *fact* about the contents of the document. This theory, on which the Court of Appeal below relied, was articulated at length in *Pacific State Bank v. Greene, supra,* 110 Cal.App.4th at pages 390–396, 1 Cal.Rptr.3d 739. However, in our view the *Greene* approach merely adds another layer of complexity to the *Pendergrass* rule,

> and depends on an artificial distinction. In *Greene,* a borrower was allegedly assured she was guaranteeing only certain indebtedness, an assurance that was both a false promise and a misrepresentation of the contract terms. The *Greene* court conceded that evidence of the promise would have been inadmissible had it not been made when the contract was executed. In this case, the *Greene* rule would exclude Ylarregui's alleged false promises in advance of the parties' agreement, but allow evidence of the same promises at the signing.

In 1977, the California Law Revision Commission ignored *Pendergrass* when it proposed modifications to the statutory formulation of the parol evidence rule. The Commission advised the Legislature to conform the terms of section 1856 with rulings handed down by this court, observing: "As the parol evidence rule exists in California today, it bears little resemblance to the statutory statement of the rule." (Recommendation Relating to Parol Evidence Rule, 14 Cal. Law Revision Com. Rep., *supra,* pp. 147–148.) The Commission identified three opinions for consideration in designing revisions to the statute. (*Pacific* ******100*** *Gas & E. Co. v. G.W. Thomas Drayage etc. Co.* (1968) 69 Cal.2d 33, 69 Cal.Rptr. 561, 442 P.2d 641, and *Masterson v. Sine* (1968) 68 Cal.2d 222, 65 Cal.Rptr. 545, 436 P.2d 561.)

Conspicuously omitted was any mention of *Pendergrass* and its nonstatutory limitation on the fraud exception. The Commission's discussion of the parol evidence rule set out the fraud exception without restriction, citing *Coast Bank v. Holmes, supra,* 19 Cal.App.3d 581, 97 Cal.Rptr. 30, which was strongly critical of *Pendergrass.* The Commission's proposed revisions were adopted by the Legislature. They included no substantive changes to the statutory language allowing evidence that goes to the validity of an agreement, and evidence of fraud in particular.

On the other hand, *Pendergrass* has had its defenders. Its limitation on evidence of fraud has been described as "an entirely defensible decision favoring the policy considerations underlying the parol evidence rule over those supporting a fraud cause of action." (*Price v. Wells Fargo Bank, supra,* 213 Cal.App.3d at p. 485, 261 Cal.Rptr. 735.) The *Price* court observed that "[a] broad doctrine of promissory fraud may allow parties to litigate disputes over the meaning of contract terms armed with an arsenal of tort remedies inappropriate to the resolution of commercial disputes." * * *

C. Pendergrass *Reconsidered*

There are multiple reasons to question whether *Pendergrass* has stood the test of time. It has been criticized as bad policy. Its limitation on the fraud exception is inconsistent with the governing statute, and the Legislature did not adopt that limitation when it revised section 1856 based on a survey of California case law construing the parol evidence rule. *Pendergrass*'s divergence from the path followed by the Restatements, the majority of other states, and most commentators is cause for concern, and leads us to doubt ***1180** whether restricting fraud claims is necessary to serve the purposes of the parol evidence rule. Furthermore, the functionality of the *Pendergrass* limitation has *****101** been called into question by the vagaries of its interpretations in the Courts of Appeal.

We respect the principle of stare decisis, but reconsideration of a poorly reasoned opinion is nevertheless appropriate.[9] It is ****323** settled that if a decision departed from an established general rule without discussing the contrary authority, its weight as precedent is diminished. (See, e.g., *Phelan v. Superior Court* (1950) 35 Cal.2d 363, 367–369, 217 P.2d 951; 9 Witkin, Cal. Procedure (5th ed. 2008) Appeal, § 537, pp. 606–608.) Accordingly, we review the state of the law on the scope of the fraud exception when *Pendergrass* was decided, to determine if it was consistent with California law at that time.

9 " 'The doctrine of stare decisis expresses a fundamental policy ... that a rule once declared in an appellate decision constitutes a precedent which should normally be followed.... It is based on the assumption that certainty, predictability and stability in the law are the major objectives of the legal system....' (9 Witkin, Cal. Procedure (3d ed. 1985) Appeal, § 758, p. 726.) * * * [However,] as this court has stated: 'Although the doctrine [of stare decisis] does indeed serve important values, it nevertheless should not shield court-created error from correction.' (*Cianci v. Superior Court* (1985) 40 Cal.3d 903, 924 [221 Cal.Rptr. 575, 710 P.2d 375].)

Earlier cases from this court routinely stated without qualification that parol evidence was admissible to prove fraud. (E.g., *Martin v. Sugarman* (1933) 218 Cal. 17, 19, 21 P.2d 428; *Ferguson v. Koch* (1928) 204 Cal. 342, 347, 268

P. 342; *Mooney v. Cyriacks* (1921) 185 Cal. 70, 80, 195 P. 922.) As the *Ferguson* court declared, "Parol evidence is always admissible to prove fraud, and it was never intended that ***1181** the parol evidence rule should be used as a shield to prevent the proof of fraud."

Historically, this unconditional rule was applied in cases of promissory fraud. For instance, in *Langley v. Rodriguez* (1898) 122 Cal. 580, 55 P. 406, the trial court excluded evidence of an oral promise by a packing company agent to make an advance payment to a grower. This court reversed, stating: " *****102** [A] promise made without any intention of performing it is one of the forms of actual fraud; and cases are not infrequent where relief against a contract reduced to writing has been granted on the ground that its execution was procured by means of oral promises fraudulent in the particular mentioned, however variant from the terms of the written engagement into which they were the means of inveigling the party. [Citations.]"

Interestingly, two years after *Pendergrass* this court fell back on the old rule in *Fleury v. Ramacciotti* (1937) 8 Cal.2d 660, 67 P.2d 339, a promissory fraud case. * * *

****324** Thus, *Pendergrass* was plainly out of step with established California law. Moreover, the authorities to which it referred, upon examination, provide little support for the rule it declared. The *Pendergrass* court relied primarily on *Towner v. Lucas' Exr., supra,* 54 Va. 705, quoting that opinion at length. (*Pendergrass, supra,* 4 Cal.2d at pp. 263–264, 48 P.2d 659.) In *Towner,* a debtor relied on an oral promise of indemnity against payment on surety bonds. ***1182** However, no fraud was alleged, nor was it claimed that the promise had been made without the intent to perform, an essential element of promissory fraud. While dicta in *Towner* provides some support for the *Pendergrass* rule, the *Towner* court appeared to be principally concerned with the consequences of a rule that mere proof of nonperformance of an oral promise at odds with the writing would establish fraud.

Pendergrass also cited a number of California cases. Yet not one of them considered the fraud exception to the parol evidence rule. (*Pendergrass, supra,* 4 Cal.2d at p. 264, 48 P.2d 659.)

[5] Accordingly, we conclude that *Pendergrass* was an aberration. It purported to follow section 1856 but its restriction on the fraud exception was inconsistent with the terms of the statute, and with settled case law as well. *Pendergrass* failed to account for the fundamental principle that fraud undermines the essential validity of the parties' agreement. When fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds. Moreover, *Pendergrass* has led to instability in the law, as courts have strained to avoid abuses of the parol evidence rule. * * * For these reasons, we overrule *Pendergrass,* and its progeny, and reaffirm the venerable maxim stated in *Ferguson v. Koch, supra,* 204 Cal. at page 347, 268 P. 342: "[I]t was never intended that the parol evidence rule should be used as a shield to prevent the proof of fraud."

***1183** [6] [7] This court took a similar action in *Tenzer v. Superscope, Inc.* (1985) 39 Cal.3d 18, 216 Cal.Rptr. 130, 702 P.2d 212 (*Tenzer*). *Tenzer* disapproved a 44–year–old line of cases to bring California law into accord with the Restatement Second of Torts, holding that a fraud action is not barred when the allegedly fraudulent promise is unenforceable under the statute of frauds. * * *

*****104** Here, as in *Tenzer,* we stress that the intent element of promissory fraud entails more than proof of an unkept promise or mere failure of performance. We note also that promissory fraud, like all forms of fraud, requires a showing of justifiable reliance on the defendant's misrepresentation. (*Lazar v. Superior Court, supra,* 12 Cal.4th at p. 638, 49 Cal.Rptr.2d 377, 909 P.2d 981.) The Credit Association contends the Workmans failed to present evidence sufficient to raise a triable issue on the element of reliance, given their admitted failure to read the contract. However, we decline to decide this question in the first instance. The trial court did not reach the issue of reliance in the summary judgment proceedings below, nor did the Court of Appeal address it.[11]

11 In *Rosenthal v. Great Western Fin. Securities Corp.* (1996) 14 Cal.4th 394, 419, 58 Cal.Rptr.2d 875, 926 P.2d 1061 (*Rosenthal*), we considered whether parties could justifiably rely on misrepresentations when they did not read their contracts. We held that negligent failure to acquaint oneself with the contents of a written agreement precludes a finding that the contract is void for fraud in the execution. In that context, "[o]ne party's misrepresentations as to the nature or character of the writing do not negate the

other party's apparent manifestation of assent, if the second party had ‘reasonable opportunity to know of the character or essential terms of the proposed contract.’ [Citation.]” (*Ibid.*) We expressed no view in *Rosenthal* on the “validity” and “exact parameters” of a more lenient rule that has been applied when equitable relief is sought for fraud in the inducement of a contract. Here as well we need not explore the degree to which failure to read the contract affects the viability of a claim of fraud in the inducement.

***1184 III. DISPOSITION**

We affirm the Court of Appeal's judgment.

WE CONCUR: CANTIL–SAKAUYE, C.J., KENNARD, BAXTER, WERDEGAR, CHIN, and LIU, JJ.

***Lewis Jorge Constr. Management, Inc. v. Pomona Unified School Dist.*, 34 Cal.4th 960, 102 P.3d 257, 22 Cal.Rptr.3d 340 (2004).**

Supreme Court of California

LEWIS JORGE CONSTRUCTION MANAGEMENT, INC., Plaintiff and Respondent,
v.
POMONA UNIFIED SCHOOL DISTRICT, et al., Defendants and Appellants.

No. S112624.

Dec. 23, 2004.

*****342 **259 *965** KENNARD, J.

A school district terminates a construction contract when the contractor, four and a half months after the promised due date, still has not finished the project. The contractor's bonding company then hires another firm to complete the project, but it suspends then later reduces the amount of bonding for the contractor. The latter successfully sues the school district for breach of contract, recovering in damages some $3 million dollars for potentially lost profits, which the contractor claimed it would have earned on prospective construction contracts it never won because of its impaired bonding capacity. The Court of Appeal concluded that those potential profits were a proper item of general damages in this action for breach of contract. We disagree.

I.

In 1994, the Pomona Unified School District (District) solicited bids for building improvements at Vejar Elementary School. The District awarded the contract to Lewis Jorge Construction Management, Inc. (Lewis Jorge), the low bidder at $6,029,000. Although the contract originally provided for completion in December of 1995, heavy rains delayed work, and the parties agreed to a ****260** revised completion date of January 22, 1996. That date came and went, but the project remained unfinished.

***966** The District withheld payments to Lewis Jorge for work completed in April and May, 1996. On June 5, the District terminated the contract with Lewis Jorge and made a demand on the contractor's surety to finish the project under the performance bond the surety had provided for Lewis Jorge. The surety then hired another contractor to complete the school *****343** project for $164,000. That contractor completed the project between early July and mid-September, 1996.

Lewis Jorge sued the District, alleging it breached the contract by declaring Lewis Jorge in default and terminating it from the construction project. The complaint sought damages and alleged six causes of action. The first, alleging breach of contract, and the second, alleging breach of an implied warranty of sufficiency of the plans and specifications for the project, are both contractual claims naming the District as a defendant. Causes of action three through five--alleging nondisclosure of material facts, inducing breach of contract, and negligence--named a district employee as a defendant. The sixth cause of action sought equitable indemnity against both the District and the employee for claims against Lewis Jorge by its surety and its unpaid subcontractors. Lewis Jorge did not plead as special damages the profits it claimed to have lost on future contracts.

Lewis Jorge, in turn, was sued by a number of its subcontractors for nonpayment of their past due bills.

At trial, Lewis Jorge presented evidence from its bonding agent that in June 1996 it had a bonding limit of $10 million per project, with an aggregate limit of $30 million for all work in progress. By mid-1997, the only sureties willing to provide Lewis Jorge with bonding imposed a limit of $5 million per project, with an aggregate limit of $15 million, a reduction of its bonding capacity to the level its surety had imposed in the early 1990's. Sometime in 1998, Lewis Jorge ceased bidding altogether and eventually closed down.

Lewis Jorge sought to prove the extent of its lost future profits on unidentified construction projects, using as the relevant period the date of the District's breach to the date of trial, and relying on its profitability during the four years preceding the breach. Robert Knudsen, a financial analyst who specialized in calculating lost profits claims, projected that Lewis Jorge had lost $95 million in gross revenue for future contracts that, based on its past history, it would likely have been awarded.

Historically, Lewis Jorge had realized a profit of about 6 percent of revenue. Knudsen calculated lost profits on unidentified projects at $4,500,000, which discounted to present value came to $3,148,107.

***967** The jury returned special verdicts in favor of Lewis Jorge, finding the District liable for $362,671 owed on the school construction contract, of which $143,755 was attributable to the District's "breach of warranty as to the fitness of its plans or specification" (the complaint's second cause of action). It awarded $3,148,197 in profits Lewis Jorge did not realize "due to the loss or reduction of its bonding capacity." Having found the District's employee negligent, the jury found him and the District jointly and severally liable for $ 3,510,868.

The District and its employee appealed. Although the Court of Appeal reversed the judgment against the District's employee, and reversed awards against the District for prejudgment interest and contractual attorney fees (Civ.Code, § 1717), it rejected the District's claim that the award to Lewis Jorge of $3,148,197 for potential profits on *****344** future projects was an improper component of *general damages* for breach of contract. The Court of Appeal granted the District's petition for rehearing on that question; after receiving additional briefing, it concluded that "the lost profit damages sought by Lewis Jorge were in the ****261** nature of general damages, [ ] not special damages as claimed by the District."

We granted the District's petition for review to resolve whether general damages for breach of a construction contract include potential profits lost on future contracts that a contractor does not win when, as a consequence of the property owner's breach, the contractor's surety reduces the contractor's bonding capacity. We later solicited and received briefing from the parties on the related issue of whether an award of lost potential profits would have been proper here as special damages.

II.

Damages awarded to an injured party for breach of contract "seek to approximate the agreed-upon performance." (*Applied Equipment Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 Cal.4th 503, 515, 28 Cal.Rptr.2d 475, 869 P.2d 454 (*Applied*).) The goal is to put the plaintiff "in as good a position as he or she would have occupied" if the defendant had not breached the contract. (24 Williston on Contracts (4th ed.2002) § 64:1, p. 7.) In other ***968** words, the plaintiff is entitled to damages that are equivalent to the benefit of the plaintiff's contractual bargain. (*Id.* at pp. 9-10; 1 Witkin, Summary of Cal. Law (9th ed. 1987) Contracts, § 813, pp. 732- 733; *Peterson v. Larquier* (1927) 84 Cal.App. 174, 179, 257 P. 873 [breach of lease permits injured party to recover difference between rental value at date of breach and rent specified in lease for its term].)

The injured party's damages cannot, however, exceed what it would have received if the contract had been fully performed on both sides. (Civ.Code, § 3358.) This limitation of damages for breach of a contract "serves to encourage contractual relations and commercial activity by enabling parties to estimate in advance the financial risks of their enterprise." (*Applied, supra,* 7 Cal.4th at p. 515, 28 Cal.Rptr.2d 475, 869 P.2d 454.)

Contractual damages are of two types--general damages (sometimes called direct damages) and special damages (sometimes called consequential damages). (24 Williston on Contracts, *supra,* § 64.1, pp. 11-12; 3 Dobbs, Law of Remedies (2d ed.1993) § 12.2(3), pp. 39-42; see, e.g., *Erlich v. Menezes* (1999) 21 Cal.4th 543, 558, 87 Cal.Rptr.2d 886, 981 P.2d 978.)

A. General Damages

General damages are often characterized as those that flow directly and necessarily from a breach of contract, or that are a natural result of a breach. (Civ.Code, § 3300 [damages "which, in the ordinary course of things, would be likely to result" from breach]; *Mitchell v. Clarke* (1886) 71 Cal. 163, 167-168, 11 P. 882 [general damages are those that naturally and necessarily result from breach].) Because general damages are a natural and necessary consequence of a contract breach, they are often said to be within the contemplation of the parties, meaning that because their occurrence is sufficiently predictable the parties at the time of contracting are "deemed" to have contemplated them. (Calamari & Perillo, The Law of Contracts (2d ed.1977) § 14-5, p. 525; *Hunt Bros. Co. v. San Lorenzo Water Co.* *****345** (1906) 150 Cal. 51, 56, 87 P. 1093 [parties need not "actually have contemplated the very consequence that occurred," but they would have supposed such a consequence was likely to follow a breach].)

B. Special Damages

Unlike general damages, special damages are those losses that do not arise directly and inevitably from any similar breach of any similar agreement. Instead, they are secondary or derivative losses arising from circumstances that are particular to the contract or to the parties. Special damages are recoverable if the special or particular circumstances from which they ***969** arise were actually communicated to or known by the breaching party (a subjective test) or were matters of which the breaching party should have been aware at the time of contracting (an objective test). (*Mitchell v. Clarke, supra,* 71 Cal. at pp. 164-167, 11 P. 882; 1 ****262** Witkin, Summary of Cal. Law, *supra,* § 815, p. 733.) Special damages "will not be presumed from the mere breach" but represent loss that " occurred by reason of injuries following from" the breach. (*Mitchell v. Clarke, supra,* 71 Cal. at p. 168, 11 P. 882.) Special damages are among the losses that are foreseeable and proximately caused by the breach of a contract. (Civ. Code, § 3300.)

California follows the common law rule that an English court articulated some 150 years ago in *Hadley v. Baxendale* (1854) 156 Eng.Rep. 145. After Hadley's mill shut down because of a broken crankshaft, he entered into a contract to have a new one built. When the builder asked Hadley to send him the broken shaft to use as a model, Hadley took it to Baxendale, a common carrier, for delivery to the builder. Baxendale did not deliver until seven days later. Hadley then sued Baxendale for lost profits for that period. Hadley's lost profits, the court held, were not recoverable, because he had failed to inform the carrier that the mill would be shut down until delivery of the new shaft. (*Id.* at p. 151.) Because the special circumstance--the mill's inoperability without a mill shaft--was not communicated to Baxendale, he did not assume the risk of compensating Hadley for mill profits lost as a result of Baxendale's late delivery of the mill shaft.

Hadley did not expressly distinguish between general and special damages. But such a distinction flows naturally from that case; hence the rule that a party assumes the risk of special damages liability for unusual losses arising from special circumstances only if it was "advised of the facts concerning special harm which might result" from breach--it is not deemed to have assumed such additional risk, however, simply by entering into the contract. (1 Witkin, Summary of Cal. Law, *supra,* § 815, p. 733; *Mitchell v. Clarke, supra,* 71 Cal. at pp. 165-169, 11 P. 882.)

The *Hadley* rule has long been applied by California courts, which view it as having been incorporated into California Civil Code section 3300's definition of the damages available for breach of a contract. (*Hunt Bros. Co. v. San Lorenzo Water Co., supra,* 150 Cal. at p. 56, 87 P. 1093; *Christensen v. Slawter* (1959) 173 Cal.App.2d 325, 334, 343 P.2d 341; *Sabraw v. Kaplan* (1962) 211 Cal.App.2d 224, 227, 27 Cal.Rptr. 81.) Contract damages, unlike damages in tort (Civ.Code, § 3333), do not permit recovery for unanticipated injury. (*Hunt Bros. Co. v. San Lorenzo Water Co., supra,* 150 Cal. at p. 56, 87 P. 1093.) ***970** Parties may voluntarily assume the risk of liability for unusual losses, but to do so they must be told, at the time the contract is made, of any special harm likely to result from a breach (*Mendoyoma, Inc. v. County of Mendocino* (1970) 8 Cal.App.3d 873, 879-880, 87 Cal.Rptr. 740; see *Erlich *****346** v. Menezes, supra,* 21 Cal.4th 543, 558-560, 87 Cal.Rptr.2d 886, 981 P.2d 978; *Brandon & Tibbs v. George Kevorkian Accountancy Corp.* (1990) 226 Cal.App.3d 442, 455-456, 277 Cal.Rptr. 40). Alternatively, the nature of the contract or the circumstances in which it is made may compel the inference that the defendant should have contemplated the fact that such a loss would be "the probable result" of the defendant's breach. (*Burnett & Doty Development Co. v. Phillips* (1978) 84 Cal.App.3d 384, 148 Cal.Rptr. 569 [defendant's delay in preparing site for subdivision breached contract with developer and subjected defendant to liability for profits that developer could not earn on unbuilt houses].) Not recoverable as special damages are those "beyond the expectations of the parties." (*Applied, supra,* 7 Cal.4th at p. 515, 28 Cal.Rptr.2d 475, 869 P.2d 454.) Special damages for breach of contract are limited to losses that were either actually foreseen (see, e.g., *Dallman Co. v. Southern Heater Co.* (1968) 262 Cal.App.2d 582, 586, 68 Cal.Rptr. 873 [in contract negotiations, supplier was put on notice that its failure to perform would result in lost profits]) or were "reasonably foreseeable" when the contract was formed. (*Applied,* at p. 515, 28 Cal.Rptr.2d 475, 869 P.2d 454.)

III.

Here, the Court of Appeal affirmed the jury's award to Lewis Jorge of $3,148,197 in *general damages,* based on profits Lewis Jorge did not earn on future unidentified contracts because its surety had reduced its ****263** bonding capacity after the District's termination of the construction contract. The Court of Appeal concluded that such potential profits were recoverable as general damages because they followed "from the breach in the ordinary course of events" and were a "natural and probable consequence." The Court of Appeal found it significant, as did the trial court, that the contract at issue, like much of Lewis Jorge's business, was a public contract that required bonding.

The Court of Appeal reasoned: When the contract was formed, the District knew of its own bond requirements, and it knew that public works contractors must provide bonds to secure their performance. Because impaired bonding capacity "has long been recognized as a direct consequence of an owner's breach of a construction contract," the Court of Appeal concluded that the District should have known that breaching the contract and resorting to the surety to complete the project could impair Lewis Jorge's ability to obtain bonds without which it could not bid on other public contracts. Accordingly, ***971** the Court of Appeal held that the potential profits Lewis Jorge lost on contracts it did not win after the District's termination of the school construction contract were general damages attributable to the District's breach. [FN3]

> FN3. The District advances various public policy arguments in urging us to preclude lost future profits as a component of general damages when the hiring party is a public entity and especially when, as here, it is a school district. Lewis Jorge responds that because public contracts require bonding, profits lost on potential projects because of impaired bonding capacity after an owner's breach of a public contract will always be general damages. Whatever the merits of these arguments, we need not base our holding on the circumstance that the contract was a public contract or that a public school district was the breaching party. For bonding, although it is statutorily required for most public contracts, is also commonly imposed under contracts between private parties for larger construction projects. (See, e.g., *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 35, 40, 86 Cal.Rptr.2d 855, 980 P.2d 407 [condominium developer required contractor to furnish a labor and materials payment bond and a performance bond for the full $3.9 million contract price].)

*****347** The Court of Appeal, however, failed to consider a threshold inquiry. If the purpose of contractual damages is to give the nonbreaching party the benefit of its contractual bargain, then the first question is: What performance did the parties bargain for? General damages for breach of a contract "are based on the value of the performance itself, not on the value of some consequence that performance may produce." (3 Dobbs, Law of Remedies, *supra,* § 12.4(1), p. 62.) Profits " 'which are the direct and immediate fruits of the contract'" are "'part and parcel of the contract itself, entering into and constituting a portion of its very elements; something stipulated for, the right to the enjoyment of which is just as clear and plain as to the fulfillment of any other stipulation.'" (*Shoemaker v. Acker* (1897) 116 Cal. 239, 245, 48 P. 62.)

Unearned profits can sometimes be used as the measure of general damages for breach of contract. Damages measured by lost profits have been upheld for breach of a construction contract when the breaching party's conduct prevented the other side from undertaking performance. (*Stark v. Shaw* (1957) 155 Cal.App.2d 171, 181, 317 P.2d 182 [contractor's delay in building subdivision prevented roofing subcontractor from performing]; *De Flavio v. Estell* (1959) 173 Cal.App.2d 226, 232-233, 343 P.2d 150 [lost profit damages below contractor's estimated profit upheld when owner repudiated contract].) The profits involved in *Stark* and *De Flavio,* however, were purely profits unearned on the very contract that was breached.

Lost profits from collateral transactions as a measure of general damages for breach of contract typically arise when the contract involves crops, goods intended for resale, or an agreement creating an exclusive sales ***972** agency. (*Nelson v. Reisner* (1958) 51 Cal.2d 161, 170-171, 331 P.2d 17 [lessor's breach of lease precluded sharecropping farmer from raising crops and realizing profit on their sale]; *Morello v. Growers Grape Prod. Assn.* (1947) 82 Cal.App.2d 365, 186 ****264** P.2d 463 [disappointed purchaser of brandy who intended to bottle and resell it]; *Brunvold v. Johnson* (1939) 36 Cal.App.2d 226, 97 P.2d 489 [termination of exclusive agent for sale of rope and twine products]; *Tahoe Ice Co. v. Union Ice Co.* (1895) 109 Cal. 242, 41 P. 1020 [termination of supply contract by ice retailer]; *Grupe v. Glick* (1945) 26 Cal.2d 680, 160 P.2d 832 [defective oil refining machines purchased for resale by exclusive agent]; see also *Brandon & Tibbs v. George Kevorkian Accountancy Corp., supra,* 226 Cal.App.3d at p. 457, 277 Cal.Rptr. 40 [where parties conceded that lost profits were the measure of damages for breach, the breach of a joint venture to expand accounting practice by acquiring an existing practice in another city supported an award of unearned profits as component of general damages for breach of contract].) The likelihood of lost profits from related or derivative transactions is so obvious in these situations that the breaching party must be deemed to have contemplated them at the inception of the contract.

We are not aware of any California authority involving a construction contract that has upheld an award of general damages against a breaching owner for profits unearned on unidentified contracts the contractor did not get when its bonding was impaired as a result of the contract breach. Lewis Jorge, nevertheless, urges *****348** us to permit such recovery, citing a Montana decision, *Laas v. Mont. Hwy. Comm'n et al* (1971) 157 Mont. 121, 483 P.2d 699. In that case the plaintiff highway contractor, who had been in business for 22 years and had made a profit on *every* construction project, claimed three years of profits lost or $250,000 for projects he was unable to win when his bonding capacity was reduced after the state breached the construction contract. The Montana Supreme Court affirmed a jury award of $78,000 in lost profits. (*Id.* at p. 130, 483 P.2d 699.) It did so without reference to the construction context, by simply applying rules for profits lost to an established business. But five years later, in *Zook Brothers Constr. Co. v. State* (1976) 171 Mont. 64, 556 P.2d 911, another case involving breach of a highway construction contract, the same court disallowed recovery of profits lost on other projects after the state's breach. The Montana court found "vague and speculative" future profits the contractor did not earn when the state's breach caused him financial woes, forcing him to sell equipment without which he was unable to take on additional work. (*Id.* at p. 76, 556 P.2d 911.) The Montana court's earlier decision in *Laas* appears to represent a singular instance of upholding lost profits on future construction projects as an item of general damages for breach of a construction contract, a holding that has not been followed in a published opinion outside Montana in the 33 years it has been on the books.

***973** The only California decision upholding damages for a contractor's lost profits on future contracts it did not win because its bonding capacity was impaired arises not, as here, from a construction contract but from a contract to provide future bonding. (*Arntz Contracting Co. v. St. Paul Fire & Marine Ins. Co.* (1996) 47 Cal.App.4th 464, 489, 54 Cal.Rptr.2d 888.) The parties to the breached contract in *Arntz* were the contractor and its surety, which agreed to provide the contractor with ongoing bonding. (*Id.* at p. 473, 54 Cal.Rptr.2d 888.) Because the contract was one for future bonding, it was entirely within the contemplation of the surety that its breach of the contract--resulting in the contractor's loss of actual bonding--would preclude the contractor from bidding on and being awarded major projects. Thus, the loss of profits on those projects were properly general damages, for they were the "direct and immediate fruits" (*Shoemaker v. Acker, supra,* 116 Cal. at p. 245, 48 P. 62) of the surety's breach of the contract to provide bonding.

Applying these rules to the school construction contract here, we cannot say that the parties' bargain included Lewis Jorge's potential profits on future construction projects it had not bid on and been awarded. Full performance by the District would have provided Lewis Jorge with full payment of the contract price. Certainly, Lewis Jorge anticipated earning a profit on the school contract with the District, but that projected profit was limited by the contract price and Lewis Jorge's costs of performance. If Lewis Jorge's bid accurately predicted its costs, ****265** the benefit of its contractual bargain for profits was capped by whatever net profit it had assumed in setting its bid price.

The District's termination of the school contract did not directly or necessarily cause Lewis Jorge's loss of potential profits on future contracts. Such loss resulted from the decision of CNA, Lewis Jorge's surety at the time of the breach, to cease bonding Lewis Jorge.

Contrary to Lewis Jorge's contention, our decision in *Warner Constr. Corp. v. City of Los Angeles* (1970) 2 Cal.3d 285, 85 Cal.Rptr. 444, 466 P.2d 996 does not compel a different result. There, a contractor *****349** sued the city for breach of a contract to construct a retaining wall. The complaint alleged four causes of action. As relevant here, the third cause of action alleged that the city had breached the contract by refusing to issue a "change order" to compensate the contractor for additional costs when soil at the site proved to be more unstable than city test holes had revealed, requiring the contractor to use special, more expensive casting methods, which did not comply with the contract's specifications. (*Id.* at p. 290, 85 Cal.Rptr. 444, 466 P.2d 996.) The fourth cause of action alleged ***974** that the city provided misleading results of two test holes it had drilled and did not disclose earlier landslides on the site. (*Id.* at pp. 290-291, 85 Cal.Rptr. 444, 466 P.2d 996.) The jury returned a general verdict for $150,000 against the city. (*Id.* at pp. 289, 300, fn. 18, 85 Cal.Rptr. 444, 466 P.2d 996.)

Of the $150,000 awarded by the jury in *Warner,* we upheld only $81,743.55 in damages. (*Warner Constr. Corp. v. City of Los Angeles, supra,* 2 Cal.3d at pp. 301, 303, 85 Cal.Rptr. 444, 466 P.2d 996.) The city had challenged the $150,000 award on the ground that it included "compensation for speculative and unproven items of damages." (*Id.* at p. 300, 85 Cal.Rptr. 444, 466 P.2d 996.) The plaintiff, relying on evidence that it had suffered impairment of capital when it funded added construction costs out of pocket, argued that it was entitled to the entire $150,000 award because of its uncompensated losses, including profits it did not earn after the city's breach. This court rejected the contention that lost profits would necessarily be speculative "[f]or an established firm such as Warner." (*Id.* at p. 301, 85 Cal.Rptr. 444, 466 P.2d 996.) We went on to state that "[l]oss of business, restriction of research, reduction of bonding capacity, and destruction of a former advantageous competitive position comprise imponderable factors which may affect different companies to differing extents and amounts." (*Ibid.*) The measure of such damages, we said, "requires proof of the effect of these factors" on the plaintiff's profits. (*Ibid.*) *Warner* did not reach the merits of the contractor's lost profits claim, however, because it concluded that the contractor had failed to prove lost profits, and therefore any award for lost profits could not "be sustained." (*Ibid.*)

Warner did *not* hold that potential profits lost from future contracts are general damages that naturally flow from a breach of a construction contract. At most, it acknowledged that to recover profits lost on future contracts the plaintiff contractor must prove their occurrence and extent. (*Warner Constr. Corp. v. City of Los Angeles, supra,* 2 Cal.3d at pp. 301-302, 85 Cal.Rptr. 444, 466 P.2d 996.) * * *

*****350 *975 **266** Having here concluded that profits Lewis Jorge might have earned on future construction projects were improperly awarded as general damages, we now decide whether those lost potential profits were recoverable as special damages. Lost profits, if recoverable, are more commonly special rather than general damages (3 Dobbs, Law of Remedies, *supra,* § 12.4(3), pp. 76-77), and subject to various limitations. Not only must such damages be pled with particularity (*Mitchell v. Clarke, supra,* 71 Cal. at p. 164, 11 P. 882), but they must also be proven to be certain both as to their occurrence and their extent, albeit not with "mathematical precision." (*Berge v. International Harvester Co.* (1983) 142 Cal.App.3d 152, 161, 190 Cal.Rptr. 815; accord, *Grupe v. Glick, supra,* 26 Cal.2d at pp. 692-693, 160 P.2d 832; *Resort Video, Ltd. v. Laser Video, Inc.* (1995) 35 Cal.App.4th 1679, 1698- 1700, 42 Cal.Rptr.2d 136.) "When the contractor's claim is extended to profits allegedly lost on *other* jobs because of the defendant's breach" that "claim is clearly a claim for special damages." (3 Dobbs, Law of Remedies, *supra,* § 12.4(3), fn. 12, p. 71.) Although Lewis Jorge did not plead its lost future profits as special damages, the issue of their availability as special damages was presented to the jury, and at oral argument the District expressly stated that it was not relying on that pleading omission.

Although a few cases state that a contractor suing for breach of contract may recover as special damages any profits it might have earned on other unawarded construction contracts, such damages are frequently denied as too speculative. (See, e.g., *Hirsch Elec. Co., Inc. v. Community Services, Inc.* (1988) 145 A.D.2d 603, 605, 536 N.Y.S.2d 141, 143 [contractor's claim that breach rendered it unable to obtain bonding, without which it could not bid or win another contract on which it would have made a profit of $800,000, was rejected as consisting of "inferences piled upon inferences" that "as a matter of law, are too speculative to give rise to the recovery of damages for lost profits"].) And there are federal decisions that likewise have rejected as too remote and speculative special damages for breach consisting of profits lost on other contracts. As one circuit court explained, "even in a common-law suit there would be no recovery for general loss of business, the claimed loss of [the contractor's entire] net worth, and losses on the non-federal work--such damages are all deemed too ***976** remote." (See, e.g., *William Green Construction Co., Inc. v. United States* (1973) 201 Ct.Cl. 616, 477 F.2d 930, 936.) These cases bar recovery of profits lost on future contracts not because the amount of the lost profits is speculative or remote, but because their occurrence is uncertain.

California, likewise, has not upheld as special damages a contractor's unearned profits after breach of the construction contract. In *****267** S.C. Anderson v. Bank of America* (1994) 24 Cal.App.4th 529, 30 Cal.Rptr.2d 286, a contractor hired to build tenant improvements did not receive timely payment from a financially strapped developer, and because of the contractor's rising receivables, its surety reduced its bonding capacity. Before the surety's action, the contractor had submitted the low bid on a public school construction project. Instead of awarding the contract to that contractor, the school district rebid the project. The contractor prepared a rebid, but could not submit its rebid because it lacked the requisite bonding capacity. Its rebid was lower than the winning bid for the school project. The contractor sued the developer's lender for fraud, seeking damages of $140,588 for profits it did not earn on the school project, amounting to 5 per cent of its rebid. The Court of Appeal affirmed nonsuit for the lender on the lost profits damages, noting there was "no evidence which would have enabled the jury to conclude it was reasonably probable" the contractor "would in fact have earned a profit" in the claimed amount. (*Id.* at p. 536, 30 Cal.Rptr.2d 286.) Although the contractor "was only obliged to demonstrate its loss with reasonable certainty" (*id.* at pp. 537-538, 30 Cal.Rptr.2d 286), the court said that the contractor had failed to show that it would be " impossible or impracticable to produce evidence relating to the accuracy of its bid, its ability to competently and efficiently perform the [school] project, or its likely net profit." (*Id.* at p. 538, 30 Cal.Rptr.2d 286.)

***977** In contrast to *S.C. Anderson,* where the lost profits claim was for a sum certain and flowing from a particular project that the contractor would likely have won as the low bidder, the lost profits Lewis Jorge claimed it would have made on future construction projects were uncertain and speculative. * * *

*****352** To summarize: It is indisputable that the District's termination of the school construction contract was the first event in a series of misfortunes that culminated in Lewis Jorge's closing down its construction business. Such disastrous consequences, however, are not the natural and necessary result of the breach of every construction contract involving bonding. Therefore, as we concluded earlier, lost profits are not general damages here. Nor were they actually foreseen or foreseeable as reasonably probable to result from the District's breach. Thus, they are not special damages in this case.

****268** DISPOSITION

The judgment of the Court of Appeal must be modified to read: "The judgment against Christopher Butler is reversed; the award of prejudgment interest is reversed; the award of attorney fees is reversed; and the award of $3,148,197 for lost profits is reversed. In all other respects, the judgment is affirmed. The matter is remanded to the trial court for an award of prejudgment interest consistent with the opinion of the Court of Appeal." As modified that judgment is affirmed.

WE CONCUR: GEORGE, C.J., BAXTER, WERDEGAR, CHIN, BROWN, and MORENO, JJ.

Rosen v. State Farm Gen. Ins. Co., 30 Cal.4th 1070, 70 P.3d 351, 135 Cal.Rptr.2d 361 (2003).

Supreme Court of California

George ROSEN, Plaintiff and Respondent,
v.
STATE FARM GENERAL INSURANCE COMPANY, Defendant and Appellant.

No. S108308.

June 12, 2003.

***1072 ***362 **353** BROWN, J.

The insurance policy in this case defined "collapse" as "actually fallen down or fallen to pieces." However, sound public policy, the Court of Appeal concluded, requires coverage for imminent, as well as actual, collapse, lest dangerous conditions go uncorrected. By failing to apply the plain, unambiguous language of the policy, the Court of Appeal erred. (Civ.Code, § 1644.) "[W]e do not rewrite any provision of any contract, [including an insurance policy], for any purpose." (*Certain Underwriters at Lloyd's of London v. Superior Court* (2001) 24 Cal.4th 945, 968, 103 Cal.Rptr.2d 672, 16 P.3d 94 (*Lloyd's of London*).)

FACTUAL AND PROCEDURAL BACKGROUND

Plaintiff submitted a claim to defendant, his homeowners insurance carrier, for the cost of repairing two decks attached to his home. Plaintiff repaired the decks upon the recommendation of a contractor who had discovered severe deterioration of the framing members supporting the decks. Plaintiff believed his decks were in a state of *imminent* collapse, entitling him to policy benefits.

Defendant denied plaintiff's claim on the ground, among others, that there had been no collapse of his decks within the meaning of the policy, in that its coverage was expressly restricted to *actual* collapse.

The "Losses Not Insured" section of plaintiff's homeowners policy provided that defendant did not insure for any loss to the dwelling caused by "collapse, except as specifically provided in SECTION I – ADDITIONAL COVERAGES, Collapse." That provision stated:

> "We insure only for direct physical loss to covered property involving the sudden, entire collapse of a *****363** building or any part of a building. [¶] Collapse means *actually fallen down or fallen into pieces.* It does not include settling, cracking, shrinking, bulging, expansion, sagging or bowing."

***1074** Plaintiff sued defendant for breach of contract and breach of the covenant of good faith and fair dealing. Defendant moved for summary judgment, arguing that plaintiff did not suffer a compensable loss because the decks did not actually collapse. In his opposition to the motion, plaintiff argued there was a material factual issue as to whether his decks were in a state of imminent collapse. Plaintiff also argued that public policy required that the collapse provision of the policy be construed to provide coverage for imminent collapse. The trial court denied defendant's motion for summary judgment, concluding there were triable issues of material fact. The parties agreed to try the case to the court on the narrow issue of whether defendant owed plaintiff policy benefits due to the *imminent* collapse of his decks.

The trial court found for plaintiff. "The public policy of the State of California is ... that policyholders are entitled to coverage for collapse as long as the collapse is imminent, *irrespective of policy language.*" The trial court declined to honor the policy's restriction of coverage because it would, in the court's view, "encourage property owners to place lives in danger in order to allow insurance carriers to delay payment of claims until the structure actually collapses...."

The Court of Appeal affirmed, holding that a homeowner's policy that expressly defines the term *collapse* as *actually fallen down or fallen into pieces* must, nevertheless, for reasons of public policy, be construed as providing coverage for *imminent* collapse.

We reverse.

DISCUSSION

"'[I]nterpretation of an insurance policy is a question of law.' (*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 Cal.4th 1, 18, 44 Cal.Rptr.2d 370, 900 P.2d 619 (*Waller*).) 'While insurance contracts have special features, they are still contracts to which the ordinary rules of contractual interpretation apply.' (*Bank of the West v. Superior Court* (1992) 2 Cal.4th 1254, 1264, 10 Cal.Rptr.2d 538, 833 P.2d 545 (*Bank of the West*).) Thus, 'the mutual intention of the parties at ****354** the time the contract is formed governs interpretation.' (*AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 821, 274 Cal.Rptr. 820, 799 P.2d 1253 (*AIU Ins.*).) If possible, we infer this intent solely from the written provisions of the insurance policy. (See *id.* at p. 822, 274 Cal.Rptr. 820, 799 P.2d 1253.) If the policy language 'is clear and explicit, it governs.' (*Bank of the* ****1075** *West, supra,* 2 Cal.4th at p. 1264, 10 Cal.Rptr.2d 538, 833 P.2d 545.)" (*Palmer v. Truck Ins. Exchange* (1999) 21 Cal.4th 1109, 1115, 90 Cal.Rptr.2d 647, 988 P.2d 568.)

As the Court of Appeal acknowledged, the policy language here was clear and explicit. "The plain language of the collapse provision in Rosen's homeowners policy is unambiguous, in that it is susceptible only of one reasonable interpretation--actual collapse of a building or a portion thereof is a prerequisite to an entitlement to policy benefits. By defining the term 'collapse' to mean 'actually fallen down or fallen into pieces,' State Farm effectively removed any ambiguity in the *****364** term collapse. Under no stretch of the imagination does actually mean imminently."

The lack of ambiguity in the collapse provision here distinguishes this case, the Court of Appeal pointed out, from the case upon which the trial court principally relied--*Doheny West Homeowners' Assn. v. American Guarantee & Liability Ins. Co.* (1997) 60 Cal.App.4th 400, 70 Cal.Rptr.2d 260 (*Doheny West*).

In *Doheny West, supra,* 60 Cal.App.4th at pages 402-403, 70 Cal.Rptr.2d 260, the homeowners association of a large condominium complex sued its property insurer for breach of contract and bad faith, alleging that the parking structure of the complex, as well as the swimming pool and associated facilities built above the parking structure, had been in a state of imminent collapse, and that the insurer had wrongfully denied a claim for the necessary repairs the association had made to the structure.

Unlike the policy in this case, the *Doheny West* policy did not specify that the reach of the term *collapse* was restricted to *actual* collapse. Instead, the *Doheny West* policy excluded coverage for collapse except "'for loss or damage caused by or resulting from risks of direct physical loss involving collapse of a building or any part of a building'" resulting from specified causes. (*Doheny West, supra,* 60 Cal.App.4th at p. 402, 70 Cal.Rptr.2d 260.) While the *Doheny West* trial court held that this language embraced imminent as well as actual collapse, the trial court found for the defendant insurer on the ground the plaintiff homeowners association had not met its burden of proving that any part of the building was in a state of imminent collapse. (*Id.* at p. 403, 70 Cal.Rptr.2d 260.)

The Court of Appeal affirmed. Noting that its task was not merely to construe the word *collapse* in isolation, but rather to construe the total coverage clause, the Court of Appeal held that the coverage clause before it "cannot be said to be clear, explicit, and unambiguous, and thus must be interpreted to protect the objectively reasonable expectations of the insured. [Citation.]" (*Doheny West, supra,* 60 Cal.App.4th at p. 405, 70 Cal.Rptr.2d 260.) With these ***1076** principles in mind, the Court of Appeal stated: "It is undisputed that the clause covers 'collapse of a building,' that is, that there is coverage if a building falls down or caves in. However, the clause does not limit itself to 'collapse of a building,' but covers 'risk of loss,' that is, the threat of loss. Further, on its terms it covers not only loss resulting from an actual collapse, but loss 'involving' collapse. Thus, with the phrases 'risk of loss,' and 'involving collapse,' the policy broadens coverage beyond actual collapse." (*Ibid.,* fn. omitted.)

However, the Court of Appeal rejected the plaintiff's contention that the policy phrases in question "broaden[ed] coverage to the extent that the clause covers 'substantial impairment of structural integrity.'" (*Doheny West, supra,* 60 Cal.App.4th at p. 405, 70 Cal.Rptr.2d 260.) The Court of Appeal concluded that the trial court had correctly interpreted the policy language before it "by requiring that [the] collapse be actual or imminent." (*Id.* at p. 406, 70 Cal.Rptr.2d 260, fn. omitted.) "This construction of the policy," the Court of Appeal observed, "avoids both the absurdity of requiring an insured to wait for a seriously damaged building to fall and the improper extension of ****355** coverage beyond the terms of the policy, and is consistent with the policy language and the reasonable expectations of the insured." (*Ibid.*)

We agree with the Court of Appeal that *Doheny West* is distinguishable from *****365** this case. As the Court of Appeal observed: "It is a well-established rule that an opinion is only authority for those issues actually considered or decided. (*Santisas v. Goodin* (1998) 17 Cal.4th 599, 620, 71 Cal.Rptr.2d 830, 951 P.2d 399; *Wilshire Ins. Co. v. Tuff Boy Holding, Inc.* (2001) 86 Cal.App.4th 627, 639, 103 Cal.Rptr.2d 480.) At no time did the court in *Doheny* [*West*] hold that an unambiguous collapse provision expressly limiting recovery to actual collapse must nevertheless be construed to provide coverage for imminent collapse. The court also did not purport to discern a public policy establishing a contractual entitlement to coverage for imminent collapse in all cases. It simply construed the ambiguous collapse provision before it, as it was required to do. (*AIU Ins.*[, *supra,*] 51 Cal.3d 807, 822, 274 Cal.Rptr. 820, 799 P.2d 1253.) In so doing, it was required to resolve the ambiguity in favor of the insured and in accordance with the reasonable expectations of the insured. (*Kazi v. State Farm Fire & Casualty Co.* (2001) 24 Cal.4th 871, 879, 103 Cal.Rptr.2d 1, 15 P.3d 223.)[¶] In construing the collapse provision in *Doheny* [*West*] to provide coverage for both actual and imminent collapse, the court expressly relied on the broad language of that particular policy. Specifically, the court held that the 'phrases "risk of loss," and "involving collapse" ' effectively 'broaden[ed] coverage beyond actual collapse.' The State Farm collapse provision at issue in this case, however, does not contain any comparable language that can be construed to extend coverage beyond actual collapse.''

***1077** However, "[n]otwithstanding the lack of ambiguity in State Farm's collapse provision," the Court of Appeal held, "as a matter of public policy, that State Farm must provide insurance benefits for imminent collapse of Rosen's two decks."

The Court of Appeal gave the following explanation for its decision not to enforce this unambiguous coverage provision: "The notion that in the absence of coverage for imminent collapse an insured may wait until the full or partial actual collapse of a building simply to ensure coverage is troubling indeed. The actual collapse of a building or any part of a building tragically can result in serious injury or loss of human life, as well as substantial property damage. A requirement that an insurer provide coverage when collapse is imminent clearly is in the best interests not only of the insured and the insured's visitors but also of the insurer. Rectifying the problem prior to an actual collapse may well save lives and money. Moreover, our holding does not unduly burden the insurer because its liability is limited for a loss which is imminent, and, thus, soon to occur anyway. Surely, an insurer's exposure to liability will be far greater in the event of an actual collapse. [¶] Any holding to the contrary would encourage property owners to risk serious injury or death or greater property damage simply to ensure that coverage would attach. We cannot and will not sanction such a result. We therefore conclude that notwithstanding the language of the collapse provision, public policy mandates that State Farm afford Rosen coverage for the imminent collapse of his decks."

Applying the same logic, with the same lack of restraint, courts could convert life insurance into health insurance. In rewriting the coverage provision to conform to their notions of sound public policy, the trial court and the Court of Appeal exceeded their authority, disregarding the clear language of the policy and the equally clear holdings of this court. In *Foster-Gardner, Inc. v. National Union Fire Ins. Co.* (1998) 18 Cal.4th 857, 77 Cal.Rptr.2d 107, 959 P.2d 265, we held that an insurer's duty to defend its insured in a "suit seeking *****366** damages" was limited to a civil action prosecuted in court, and did not extend to a proceeding conducted before an administrative agency pursuant to an environmental statute. The Court of Appeal in *Fireman's Fund Ins. Co. v. Superior Court* (1997) 65 Cal.App.4th 1205, 78 Cal.Rptr.2d 418, we noted with approval, had rejected the "suggestion ... 'because it is in the nation's best interests to have hazardous waste cleaned up, our courts must construe ****356** insurance policies to provide coverage for such remedial work lest the insureds be discouraged from cooperating with the EPA.'" (*Foster- Gardner,* at p. 888, 77 Cal.Rptr.2d 107, 959 P.2d 265.) "[T]he Court of Appeal in *Fireman's Fund* aptly stated, 'While we agree that it is in everyone's best interests to have hazardous wastes cleaned up, we do not ***1078** agree that a California court may rewrite an insurance policy for that purpose or for any purpose. This is a contract issue, and imposition of a duty to defend CERCLA proceedings that have not ripened into suits would impose on the insurer an obligation for which it may not be prepared.... Whatever merit there may be to these conflicting social and economic considerations, they have nothing whatsoever to do with our determination whether the policy's disjunctive use of "suit" and "claim" creates an ambiguity.' (*Fireman's Fund, supra,* 65 Cal.App.4th at p. 1214, fn. 8, 78 Cal.Rptr.2d 418, see also *AIU [Ins.], supra,* 51 Cal.3d at p. 818, 274 Cal.Rptr. 820, 799 P.2d 1253 ['The answer is to be found solely in the language of the policies, not in public policy considerations'].)" (*Ibid.,* fn. omitted.)

In *Lloyd's of London, supra,* 24 Cal.4th 945, 103 Cal.Rptr.2d 672, 16 P.3d 94, we held that an insurer's duty to indemnify its insured for "all sums that the insured becomes legally obligated to pay as damages" is limited to money ordered by a court, and does not extend to expenses required by an administrative agency pursuant to an environmental statute. We rejected the argument that we should rewrite the indemnification provision, extending it to cleanup orders issued by an environmental agency, in order "to advance the cleanup of a contaminated site and the abatement of the contamination's effects by calling in the insurer's resources in supplement to those of an insured that is prosperous or in place of those of an insured that is not. Our reason is that we do not rewrite any provision of any contract, including the standard policy underlying any individual policy, for any purpose. (See *Aerojet- General Corp. v. Transport Indemnity Co.* [(1997)] 17 Cal.4th [38,] 75-76, 70 Cal.Rptr.2d 118, 948 P.2d 909.) To do so with regard to the standard policy, with which we are here concerned, might have untoward effects generally on individual insurers and individual insureds and also on society itself. Through the standard policy, individual insurers made promises, and individual insureds paid premiums, against the risk of loss. To rewrite the provision imposing the duty to indemnify in order to remove its limitation to money ordered by a court might compel insurers to give more than they promised and might allow insureds to get more than they paid for, thereby denying their 'general[ ] free[dom] to contract as they please[ ]' of any effect in the matter. (*Id.* at p. 75, 70 Cal.Rptr.2d 118, 948 P.2d 909; accord, *Linnastruth v. Mut. Benefit etc. Assn.* (1943) 22 Cal.2d 216, 218, 137 P.2d 833.) It is conceivable that to rewrite the provision thus might result in providing society itself with benefits that might outweigh any costs that it might impose on individual insurers and individual insureds. It is conceivable. But unknown. Knowledge 'depend[s] in large part on' what we are ill suited for, that is, the 'amassing and analyzing of *****367** complex and extensive empirical data.' (*Aerojet-General Corp. v. Transport Indemnity Co., supra,* 17 Cal.4th at p. 76, 70 Cal.Rptr.2d 118, 948 P.2d 909.) Without such knowledge we could not proceed." (*Lloyd's of London, supra,* 24 Cal.4th at pp. 967-968, 103 Cal.Rptr.2d 672, 16 P.3d 94.)

Plaintiff contends that recent legislation establishing a limited new cause of action for certain specified housing defects (Sen. Bill No. 800 (2001-2002 ***1079** Reg. Sess.) chaptered as Stats.2002, ch. 722, § 3 [adding Civ.Code, § 895 et seq., eff. Jan. 1, 2003]), read in light of our decision in *Aas v. Superior Court* (2000) 24 Cal.4th 627, 101 Cal.Rptr.2d 718, 12 P.3d 1125 (*Aas*), provides this court with a statutory basis for refusing to enforce the plain language restricting the coverage of this policy for collapse to actual collapse. The contention lacks merit.

In *Aas, supra,* 24 Cal.4th 627, 101 Cal.Rptr.2d 718, 12 P.3d 1125, we applied the economic loss rule in a negligence action by homeowners against the developer, contractor, and subcontractors who built their dwellings. The plaintiffs alleged that their homes suffered from many construction defects, but they conceded that many of the defects had ****357** caused no bodily injury or property damage. The trial court barred them from introducing evidence of the defects that had caused no injury to persons or property. We upheld the trial court's ruling. We explained that under the economic loss rule, "appreciable, nonspeculative, present injury is an essential element of a tort cause of action." (*Id.* at p. 646, 101 Cal.Rptr.2d 718, 12 P.3d 1125.)" Construction defects that have not ripened into property damage, or at least into involuntary out-of-pocket losses," we held, "do not comfortably fit the definition of '"appreciable harm"' – an essential element of a negligence claim.'' (*Ibid.*)

In enacting Senate Bill No. 800 (2001-2002 Reg. Sess.), the Legislature sought to respond to, among other things, "concerns expressed by homeowners and their advocates over the effects" of our decision in *Aas, supra,* 24 Cal.4th 627, 101 Cal.Rptr.2d 718, 12 P.3d 1125 "that defects must cause actual damage prior to being actionable in tort." (Sen. Com. on Judiciary, Analysis of Sen. Bill No. 800 (2001-2002 Reg. Sess.) as amended Aug. 28, 2002, p. 1.) In summary, Senate Bill No. 800 "[p]rovides for detailed and specific liability standards for newly constructed housing. Establishes definitions of construction defects. Creates a new prelitigation process that requires that claimants alleging a defect give builders notice of the claim, following which the builder has an absolute right to repair before the homeowner can sue for a violation of those standards. [¶] If the builder fails to acknowledge the claim within the time specified, elects not to go through the statutory process, fails to request an inspection within the time specified, or declines the offer to repair, or if the repair is inadequate, the homeowner is relieved from any further prelitigation process. Provides third-party inspectors with immunity from liability."

Senate Bill No. 800 (2001-2002 Reg. Sess.), plaintiff argues, "affords this Court with the statutory basis for rejecting [defendant's] actual ***1080** collapse definition: requiring [plaintiff] to wait for the decks to actually collapse off the side of his home before coverage would attach is akin to requiring a homeowner to wait for damage to result from a defect before he can sue the homebuilder." Plaintiff's analogy fails. Senate Bill No. 800 is applicable "only to *****368** residences originally sold on or after January 1, 2003." (Civ.Code, § 938.) It is one thing for the Legislature to rewrite the rules for construction defect litigation for homes sold in the future. In *Aas,* we emphasized that "the Legislature may add whatever additional protections it deems appropriate...." (*Aas, supra,* 24 Cal.4th at p. 653, 101 Cal.Rptr.2d 718, 12 P.3d 1125.) However, it would be quite another thing for this court to rewrite the coverage provision of an existing homeowners insurance policy to remove a restriction. Again, by agreeing to this contract of insurance, the insurer made promises, and the insured paid premiums, against the risk of loss. To rewrite the provision imposing the duty to indemnify in order to remove its limitation to actual collapse would compel the insurer to give more than it promised and would allow the insured to get more than it paid for, thereby denying their freedom to contract as they please. (*Lloyd's of London, supra,* 24 Cal.4th at pp. 967-968, 103 Cal.Rptr.2d 672, 16 P.3d 94.)

DISPOSITION

The judgment of the Court of Appeal is reversed and the matter remanded for further proceedings consistent with this opinion.

WE CONCUR: GEORGE, C.J., and BAXTER, CHIN, JJ.

Concurring Opinion by MORENO, J.

I concur with the result. I also concur in the majority's conclusion that the coverage provision is unambiguous in this case. But I do not agree with the majority's conclusion that courts are forbidden from employing public policy when determining how insurance policy clauses are to be interpreted and enforced. * * *

****358** Notwithstanding the categorical statements of the majority and of *Lloyd's of London,* it is still true that we will not enforce terms of contracts that ***1081** violate public policy. The public policy in question may sometimes be based on statute (see, e.g., *Wildman v. Government Employees Ins. Co.* (1957) 48 Cal.2d 31, 307 P.2d 359) but does not necessarily have to be--it can be based on other policies perceived to be contrary to the public welfare. (See *Altschul v. Sayble* (1978) 83 Cal.App.3d 153, 162, 147 Cal.Rptr. 716 [court refuses to enforce fee-for-referral agreements among attorneys as contrary to public policy].) We have never held that this principle is inapplicable to insurance contracts. (See *AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 821-822, 274 Cal.Rptr. 820, 799 P.2d 1253 [general contract principles are applicable to insurance contracts].)

Indeed, in some instances, courts have modified or supplemented language in insurance policies on essentially public policy *****369** grounds. For example, courts have held that, notwithstanding clauses in insurance policies that require the insured's cooperation and timely notice of a claim to an insurer, breach of those terms would not serve as a defense to insurance coverage if the insurer has not been prejudiced thereby. (*Northwestern Title Security Co. v. Flack* (1970) 6 Cal.App.3d 134, 140, 85 Cal.Rptr. 693; *Campbell v. Allstate Ins. Co.* (1963) 60 Cal.2d 303, 306, 32 Cal.Rptr. 827, 384 P.2d 155.)

The argument in favor of the Court of Appeal's and the insured's position takes the above principles as a point of departure. The Court of Appeal reasoned that there are compelling public policy grounds not to enforce the "actual collapse" limitation at issue here when it would preclude coverage for imminent collapse. As the court stated: "The notion that in the absence of coverage for imminent collapse an insured may wait until the full or partial actual collapse of a building simply to ensure coverage is troubling indeed. The actual collapse of a building or any part of a building can tragically result in serious injury or loss of human life, as well as substantial property damage. A requirement that an insurer provide coverage when collapse is imminent clearly is in the best interests not only of the insured and the insured's visitors but also of the insurer. Rectifying the problem prior to an actual collapse may well save lives and money. Moreover, our holding does not unduly burden the insurer because its liability is limited for a loss that is imminent, and, thus, soon to occur anyway. Surely, an insurer's exposure to liability will be far greater in the event of an actual collapse." * * *

****359 *1082** The Court of Appeal's reasoning is not without force. An insurance policy that clearly establishes a financial incentive to maintain a hazardous condition injurious to the public may well be contrary to public policy. This case is therefore distinguishable from those cases cited by the majority in which enforcement of a policy exclusion would not create such a perverse incentive but merely retard the accomplishment of some worthwhile goal, such as cleanup of hazardous wastes. (See, e.g., *Foster-Gardner, Inc. v. National Union Fire Ins. Co.* (1998) 18 Cal.4th 857, 77 Cal.Rptr.2d 107, 959 P.2d 265.)

The Court of Appeal's reasoning is, however, ultimately unpersuasive. In determining whether a contract violates public policy, courts essentially engage in a weighing process, balancing the interests of enforcing the contract with those interests against enforcement. (*Bovard v. American Horse Enterprises, Inc.* (1988) 201 Cal.App.3d 832, 840-841, 247 Cal.Rptr. 340, citing Rest.2d Contracts, § 178.) But the cases make clear that the judicial power to declare public policy in the context of contract interpretation and enforcement should be exercised with great caution. "'"The power of the courts to declare a contract void for being in contravention of sound public policy is a very delicate and undefined power, and, like the power to declare a statute unconstitutional, should be exercised only in cases free from doubt.' [Citation.] ... 'No court ought to refuse its aid to enforce a contract on doubtful and uncertain grounds. The burden is on the [one challenging the contract] to show that its enforcement would be in violation of the settled public policy of this state, or injurious to the morals of its people.'"" *****370** (*Bovard v. American Horse Enterprises, Inc., supra,* 201 Cal.App.3d at p. 839, 247 Cal.Rptr. 340.)

In this case, there is a strong public policy in favor of allowing insurers to enforce unambiguous policy provisions, thereby encouraging stability in the insurance industry and allowing insurers the benefit of the bargain created by such unambiguous language. On the other hand, the extent of the danger to the public that the Court of Appeal and plaintiff identify is very much in doubt. The argument that literal enforcement of the policy provision at issue will create substantial financial incentives to allow decks to collapse so as to injure the public ignores the existence of various countervailing disincentives. These include the tort duty imposed on property owners not to injure others through their property's hazardous conditions, as well as the strong interest in keeping oneself, one's family, and persons invited onto one's property, free from harm. Nor can we say with confidence that the Court of Appeal's conclusion is correct that its holding would ultimately benefit the insurer--the insurer is in a far better position to make that determination. Given these doubts, and given the strong policy in favor of enforcing ***1083** unambiguous terms, I cannot say the insured has carried its burden of demonstrating that public policy compels us to invalidate or reinterpret the "actual collapse" provision of this insurance policy.

WE CONCUR: KENNARD and WERDEGAR, JJ.

Purcell v. Schweitzer, 224 Cal.App.4th 969, 169 Cal.Rptr.3d 90 (2014).

Court of Appeal, California.
Fourth District, Division 1.

Lennox A. PURCELL, Plaintiff and Appellant,
v.
Michael SCHWEITZER, Defendant and Respondent.

D063435
Filed 2/24/2014

***970 **91** APPEAL from a judgment of the Superior Court of San Diego County, Earl H. Maas III, Judge. Affirmed. (Super. Ct. No. 37-2009-00059423-CU-BC-NC)

****92 Opinion**

NARES, Acting P.J.

***971** This action arises out of a promissory note in the amount of $85,000 given by defendant Michael Schweitzer to plaintiff Lennox A. Purcell. After Schweitzer defaulted on the promissory note, Purcell brought a lawsuit seeking to recover the monies he had loaned him. The parties settled the action, with Schweitzer agreeing to pay the sum of $38,000, along with interest at the rate of 8.5 percent, in installments over 24 months. The settlement agreement also provided that payments were due on the first day of each month. To be considered timely, payment had to be received no later than the fifth day of the month. Of relevance to this appeal, the agreement provided that if a payment was not made on time, it was considered a breach of the entire settlement agreement, making the entire original liability of $85,000 due. The agreement also specified that that provision did not constitute an unlawful "penalty" or "forfeiture."

When Schweitzer was late on a payment, Purcell sought and was granted a default judgment in the amount of $58,829.35. Schweitzer thereafter brought a motion to set aside the default judgment, asserting the default judgment was the result of an unlawful penalty. The court set aside the default judgment, finding that it constituted an unenforceable penalty because the amount of the judgment bore no reasonable relationship to the amount of damages Purcell would actually suffer as a result of Schweitzer's breach.

Purcell appeals, asserting the court erred in setting aside the judgment because (1) Schweitzer waived his right to challenge the judgment on any grounds; and (2) the judgment did not constitute an unenforceable penalty because it fairly represented the amount of his damages. We affirm.

*972 FACTUAL AND PROCEDURAL BACKGROUND

A. *The Original Lawsuit and Settlement*

In September 2009 Purcell brought a lawsuit against Schweitzer and others to recover the money he loaned them. In March 2010 Schweitzer signed a settlement agreement with Purcell. Pursuant to that agreement, Schweitzer agreed to pay Purcell the sum of $38,000, along with interest on the unpaid principal at the rate of 8.5 percent in installments over 24 months. Monthly payments by Schweitzer then began on April 1, 2010, with a balloon payment of all remaining principal and accrued interest due on April 1, 2012. Schweitzer was to make an initial payment of $20,000, with the monthly payments of $750 occurring thereafter. The payments Schweitzer made under the payment plan ranged from $750 to $1,332.58.

The settlement agreement also provided that all payments by Schweitzer were due on the first day of each month and considered ****93** late if not actually received by the fifth calendar day of the month. Moreover, the settlement agreement provided that in the event of such a breach, a judgment for the full amount of Schweitzer's original liability of $85,000 could be entered against him. The stipulation for entry of judgment attached to the settlement agreement further provided that the $85,000 "is an agreed upon amount of monies actually owed, jointly and severally, by the Defendant [Schweitzer] to the Plaintiff [Purcell] and *is neither a penalty nor is it a forfeiture.*" (Italics added.) That section also provided that the $85,000 took into consideration "the economics associated with proceeding further with this matter, including but not limited to: [¶] (1) A fully performed settlement; [¶] (2) Limiting the continuing attorneys' fees and costs relating to litigation; [¶] (3)Limiting attorneys' fees and costs relating to post-judgment procedures, including without limitation debtor examinations, debtor and asset searches, levies, writs, assignments and sister-state judgments; [¶] (4) Elimination of uncertainties relating to collection of a Judgment in contrast to a full, voluntary payment and performance by Defendant; and [¶] (5) Support for the public policy of judicial economy."

Finally, the agreement provided that Schweitzer waived any right to an appeal and any right to contest or otherwise set aside the judgment whether pursuant to Civil Code section 3275 "or otherwise."

B. *The Second Default Judgment*

In October 2011 Schweitzer failed for the first time to make a monthly payment on time, paying it on October 11 instead of October 5. Purcell accepted that payment, even though it was late.

***973** Nevertheless, Purcell applied for entry of judgment, and judgment was thereafter entered on October 17, 2011, in the amount of $58,829.35, with $58,101.85 of that amount identified as consisting of "punitive damages."

Thereafter, Schweitzer continued to make payments pursuant to the stipulated payment plan, making monthly payments in November and December 2011. The December payment was the last payment due.

According to Schweitzer, he was informed by Purcell's attorney in August 2012 that there was a balance remaining on the payment plan of $67.42. Purcell denies that he or his attorney ever said the balance due was $67.42. Rather, Purcell states that the balance was $1,776.58 and supports this contention by pointing out that Schweitzer paid that amount in August 2012. Payment of that balance was accepted by Purcell. Thus, as of August 2012, the settlement had been paid in full.

C. *Motion To Set Aside Default Judgment & Court's Order*

Schweitzer thereafter brought a motion to set aside the second default judgment. ****94** * * * The court granted the motion to set aside the default judgment, finding the damages sought by Purcell bore no rational relationship to the damages Purcell would actually suffer as a result of Schweitzer's breach. The court further found Schweitzer's waiver was unenforceable as against public policy.

*974 DISCUSSION

I. *STANDARD OF REVIEW*

Because we are presented with a question of law on undisputed facts, our review is de novo.

II. *ANALYSIS*

"[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 under the circumstances existing at the time the contract was made*." (§ 1671, subd. (b), italics added.)

However, a liquidated damages clause becomes an unenforceable penalty "if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach." (*Ridgley v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970, 977, 73 Cal.Rptr.2d 378, 953 P.2d 484.) "The ****95** amount set as liquidated damages 'must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained.' " (*Ibid.*) "Absent a relationship between the liquidated damages and the damages the parties anticipated would result from a breach, a liquidated damages clause will be construed as an unenforceable penalty." (*Morris v. Redwood Empire Bancorp* (2005) 128 Cal.App.4th 1305, 1314, 27 Cal.Rptr.3d 797.)

Greentree Financial Group. Inc. v. Execute Sports, Inc. (2008) 163 Cal.App.4th 495, 78 Cal.Rptr.3d 24 (*Greentree*), is instructive. The plaintiff brought an action for breach of contract against the defendant, alleging the defendant failed to pay $45,000 due under the contract. The parties settled the action, which was memorialized in a stipulation for entry of judgment. The stipulation provided defendant would pay a total of $20,000 in two installments, but if defendant defaulted, plaintiff was entitled to have judgment entered against defendant for the full amount prayed for in the complaint. After defendant defaulted on the first installment payment of $15,000, plaintiff succeeded in having a judgment entered for $61,232, consisting of $45,000 in damages, $13,912 in prejudgment interest, $2,000 in attorney fees, and $320 in costs. (*Id.* at p. 498, 78 Cal.Rptr.3d 24.)

In reversing and directing the trial court to reduce the judgment to $20,000, the Court of Appeal concluded the stipulated judgment amount constituted an unenforceable penalty under section 1671. (*Greentree, supra,* 163 Cal.App.4th at pp. 500–501, 78 Cal.Rptr.3d 24.)

The *Greentree* court further explained that under section 1671, subdivision (b), a liquidated damages clause constitutes an unenforceable penalty " 'if it ***975** bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. The amount set as liquidated damages "must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained." [Citation.] In the absence of such relationship, a contractual clause purporting to predetermine damages "must be construed as a penalty." ' " (*Greentree, supra*, 163 Cal.App.4th at p. 499, 78 Cal.Rptr.3d 24.)

Further, the relevant breach to be analyzed "is the breach of the stipulation, not the breach of the *underlying contract*." (*Greentree, supra*, 163 Cal.App.4th at p. 499, 78 Cal.Rptr.3d 24.) In *Greentree,* the stipulation provided for payment of $20,000. But rather than attempting to anticipate the possible damages resulting from breach of the *stipulation,* the parties had designated the full amount claimed as damages in the underlying lawsuit. The Court of Appeal concluded the $61,232 judgment bore "no reasonable relationship to the range of actual damages the parties could have anticipated from a breach of the stipulation to settle the dispute for $20,000. '[D]amages for the withholding of money are easily determinable—i.e., interest at prevailing rates....' [Citation.] The amount of the judgment, however, was more than triple the amount for which the parties agreed to settle the case." (*Id.* at p. 500, 78 Cal.Rptr.3d 24.)

Purcell attempts to distinguish the *Greentree* case on the basis that the Court of Appeal there was not confronted with a situation where the defendant provided an "express waiver" of any challenges to the stipulated judgment "on any basis." He also asserts that the parties agreed that the amount of the stipulated judgment reflected the economics of proceeding further with the matter.

However, "the public policy expressed in Civil Code sections 1670 and 1671 *may not be circumvented by words used in a contract*; that whether or not a particular clause is a penalty or forfeiture or a bona fide provision for liquidated damages depends upon the actual facts existing at the time the contract is executed and whether or not, in fact, it was then impracticable or extremely difficult to fix actual damages and that the parties did in fact then make a good faith and reasonable effort to do so; that 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. The applicability of Civil Code section 1671 depends upon the actual facts *not the words which may have been used in the contract*." (*Cook v. King Manor and Convalescent Hospital* (1974) 40 Cal.App.3d 782, 792, 115 Cal.Rptr. 471, italics added.)

Here, the stipulation that allowed for entry of judgment in the amount of almost $60,000 was likewise an unenforceable penalty because the underlying settlement was for $38,000. The stipulation bore no reasonable relationship to the damages that it could be expected that Purcell would suffer as a ***976** result of a breach by Schweitzer. This is shown by the payment plan itself, which provided that Schweitzer would make payments of $750 per month. Indeed, Purcell suffered no damages at all because judgment was entered on October 17, *after* payment was accepted on October 11.

* * *

****96** Finally, the judgment was improperly entered as "punitive damages." Punitive damages are not recoverable in breach of contract actions. (*Myers Building Industries, Ltd. v. Interface Technology, Inc.* (1993) 13 Cal.App.4th 949, 960, 17 Cal.Rptr.2d 242.)

DISPOSITION

The order setting aside the default judgment is affirmed. Respondent shall recover his costs on appeal.

WE CONCUR:
HALLER, J.
McDONALD, J.

Begl Construction Co., Inc. v. Los Angeles Unified School Dist., 154 Cal.App.4th 970, 66 Cal.Rptr.3d 110 (2007).[1]

Court of Appeal, Second District, Division 4, California.

BEGL CONSTRUCTION COMPANY, INC., et al., Plaintiffs, Cross-defendants, and Appellants, v. LOS ANGELES UNIFIED SCHOOL DISTRICT, Defendant, Cross-complainant and Appellant; Star Insurance Company, Cross-defendant and Respondent.

No. B181933.

Aug. 29, 2007.
Certified for Partial Publication.;

***110** EPSTEIN, P.J.

This case arises from a public works construction contract entered into by appellant Los Angeles Unified School District (the District) and cross-appellant BEGL Construction Company, Inc. (BEGL).

The District argues the trial court abused its discretion in admitting evidence of BEGL's lost profits due to impaired bonding capacity. We reject that argument.

We shall affirm the judgment.

FACTUAL AND PROCEDURAL SUMMARY

In August 2000, the District awarded BEGL a public works construction contract for a seismic retrofit of the Science Building at its Los Angeles Center for Enriched Studies (LACES), and for the demolition and reconstruction of the LACES West Arcade. Because the project was a public work, BEGL was required to post a performance and payment bond. After BEGL started the project, the West Arcade work was removed from the scope of the contract.

The District terminated BEGL in January 2002. It then filed a bond claim with BEGL's surety, Fidelity & Deposit Company of Maryland (Fidelity), for completion of the LACES project. The District and Fidelity entered into a takeover agreement, and Fidelity hired another contractor to finish the project. Fidelity then sued BEGL. That case was later settled.

In April 2003, BEGL filed an action against the District for breach of contract and breach of warranty of plans and specifications. BEGL alleged the District breached the contract between them by: "a. Failing to issue a notice to proceed in a timely manner; [¶] b. Supplying inadequate and faulty plans and specifications; [¶] c. Failing to supply necessary design information in a reasonable and timely manner; [¶] d. Failing to provide sufficient qualified representatives to provide for timely resolution of design and other technical issues; [¶] e. Failing to cooperate with plaintiff to allow for the efficient and timely completion of the project; [¶] f. Frustrating, obstructing, hindering and interfering***112** with plaintiff's performance of the project; [¶] g. Demanding that plaintiff perform work which was not an agreed part of plaintiff's scope of work; [¶] h. Failing to disclose pertinent information in defendants' possession and control, when such information was relevant and necessary for the proper and timely completion of the project; [¶] i. Failing to process requests for information and clarification in an efficient and timely manner; [¶] j. Failing to process change order requests in a timely manner[;][¶] k. Failing to grant plaintiff extra time to complete the project due to delays ...; [¶] l. Failing to pay plaintiff sums due under the contract, extra work and changes; [¶] m. Failing to pay plaintiff sums due for delays, disruptions, and impacts in the work; [¶] n. Failing to pay plaintiff interest and penalties under Public Contract Code section § 7107, and like statutes, for the LAUSD's failure to make payments promptly; and [¶] o. Unlawfully terminating the contract."

A jury found that both BEGL and the District had breached the contract, and awarded BEGL $954,197 in damages and the District $1 in damages. After several post-trial motions by both

[1] **Note**: The Supreme Court subsequently denied the School District's petition for review but also ordered the opinion not published in the official reporter. It has been included as a counterpoint to the *Lewis Jorge* case, above.

parties, the District filed a timely notice of appeal. BEGL filed a timely cross-appeal.

DISCUSSION

I

At trial, BEGL argued that as a result of the District's breach of contract, its bonding capacity was diminished, causing BEGL to lose $506,000 in profits. After beginning the LACES project, which was bonded by Fidelity, BEGL began doing business with a new surety, CNA. BEGL then moved from CNA to INSCO/DICO. In 2002, BEGL's bonding capacity was $3 million to $4 million per job, and $6 million to $7 million aggregate for all work in progress. INSCO/DICO decided to stop bonding BEGL in November 2002 after it learned of the dispute between Fidelity and BEGL regarding the LACES project. BEGL's bonding agent tried to place BEGL with another surety, but he was unsuccessful. Sureties would not bond BEGL because of the current dispute between Fidelity and BEGL. Eventually, BEGL was bonded for $500,000 per job, and $500,000 aggregate.

Consistent with its position before and during trial, the District argues the trial court abused its discretion in admitting evidence of BEGL's lost profits. The District's primary contention is that because it was not foreseeable at the time of contracting***113** that BEGL would lose profits as a result of the District's breach, the damages are improper as a matter of law, and thus the evidence should not have been admitted.

The basic law on secondary or derivative damages from breach of contract was established over 150 years ago in the celebrated English precedent, *Hadley v. Baxendale* (1854) 156 Eng.Rep. 145. That decision has been followed and applied in California through Civil Code section 3300 and a series of cases, beginning with *Hunt Bros. Co. v. San Lorenzo etc. Co.* (1906) 150 Cal. 51, 56, 87 P. 1093.

Our Supreme Court's most recent and definitive application of this law in the context of a construction contract is in *Lewis Jorge Construction Management, Inc. v. Pomona Unified School Dist.* (2004) 34 Cal.4th 960, 973, 975, 22 Cal.Rptr.3d 340, 102 P.3d 257(*Lewis Jorge*).[FN1] In that case, the court held that loss of potential profits on unearned future construction projects due to impaired bonding capacity was not recoverable as general damages because "[t]he District's termination of the school contract did not directly or necessarily cause Lewis Jorge's loss of potential profits on future contracts. Such loss resulted from the decision of CNA, Lewis Jorge's surety at the time of the breach, to cease bonding Lewis Jorge." (*Id.* at p. 973, 22 Cal.Rptr.3d 340, 102 P.3d 257.) But the court did not foreclose the availability of lost profits as secondary or special damages. "Special damages are recoverable if the special or particular circumstances from which they arise were actually communicated to or known by the breaching party (a subjective test) or were matters of which the breaching party should have been aware at the time of contracting (an objective test)." (*Id.* at pp. 968-969, 22 Cal.Rptr.3d 340, 102 P.3d 257.)

> FN1. *Lewis Jorge* was decided about a month after the jury verdict in this case. BEGL argues that to the extent *Lewis Jorge* establishes new standards regarding lost profits due to diminished bonding capacity, it would be "fundamentally unfair" to apply the case retroactively. Because *Lewis Jorge* only applies existing law, we find no reason not to apply the case here.

Under the facts in *Lewis Jorge,* the court held that loss of potential profits on future unearned construction projects was not recoverable as special damages because the "[e]vidence at trial established that the owner's terminating a contract might or might not cause the contractor's surety to reduce its bonding capacity. As the District pointed out at oral argument, when it signed the contract it did not know what Lewis Jorge's balance sheet showed or what criteria Lewis Jorge's surety ordinarily used to evaluate a contractor's bonding limits. Absent such knowledge, the profits Lewis Jorge claimed it would have made on future, unawarded contracts were not actually foreseen nor reasonably foreseeable." (*Lewis Jorge, supra,* 34 Cal.4th at p. 977, 22 Cal.Rptr.3d 340, 102 P.3d 257.)

Unlike the showing in *Lewis Jorge,* in this case there is sufficient evidence of foreseeability. BEGL's bonding agent, Matthew Welty, stated that "[w]henever there's a dispute between a surety company, whether there's a lawsuit between-where a contractor is suing a bonding company or vice versa, no other surety company wants to do business with that contractor until that is resolved."

District witness Jordan S. Rosenfeld, a certified public accountant and member of the National

Bond Claims Association, stated that "when the surety has a dispute with the contractor, they typically don't get bonded." In explaining several factors ***114** contributing to BEGL's inability to obtain bonding, Rosenfeld went on to say that "F & D had to step in as the surety for [BEGL] on this project and finish the job. They had incurred costs and [were] now looking to [BEGL] and the personal indemnitors to repay them. Once a company has an outstanding issue like that, sureties no longer will provide bonds until satisfaction is accomplished."

Another District witness, Gregg Okura, the vice-president of underwriting at INSCO/DICO, testified that it was "the general policy" in "the bonding industry that as soon as a bond company learns of a dispute between a contractor and a bond company, they don't write further bonds for that contractor."

During a meeting regarding the LACES project, the District's construction manager "stated that if BEGL decides to abandon the job, [the District] would contact their bonding company to inform them of the situation. [He] stated that the District is not in the *business of breaking contractors* but if BEGL decides not [to] comply with the plans and specifications, the District has the right under FORM 82.39, to finish the job by whatever means necessary." (Italics added.)

Although the District may not have known what BEGL's balance sheet showed, or what criteria BEGL's surety used to determine bonding capacity, the evidence established an industry custom that where there is a dispute between a surety and a contractor, the contractor will not be bonded so long as the dispute remains unresolved. Unlike the equivocal showing in *Lewis Jorge,* where the "owner's terminating a contract *might or might not* cause the contractor's surety to reduce its bonding capacity," in this case, the evidence of industry custom was unequivocal. (Cf. *Lewis Jorge, supra,* 34 Cal.4th at p. 977, 22 Cal.Rptr.3d 340, 102 P.3d 257, italics added.) The statement of the District's construction manager about "breaking" contractors demonstrates that the District was aware of the industry custom, and knew that terminating BEGL and filing a claim with Fidelity could do just that.

Because the evidence was sufficient for a trier of fact to reasonably find that BEGL's lost profits due to impaired bonding capacity resulting from the District's breach, were foreseeable to the District at the time of contracting, the court did not abuse its discretion in admitting evidence of lost profits. The jury was properly instructed that in order to award such damages, it had to first find forseeability: "[BEGL] also claims damages for loss of future profits and damage to its bonding capacity. To recover for harm, BEGL must prove that when the parties made the contract [the District] knew or reasonably should have known of the special circumstances leading to such harm." (Italics omitted.)

The District argues that because there was no evidence in the record "as to any project that BEGL would likely have won as the low bidder or any sum flowing from any project," the lost profits damages are speculative and uncertain. "Lost anticipated profits cannot be recovered if it is uncertain whether any profit would have been derived at all from the proposed undertaking. But lost prospective net profits may be recovered if the evidence shows, with reasonable certainty, both their occurrence and extent. [Citation.]" (*S.C. Anderson, Inc. v. Bank of America* (1994) 24 Cal.App.4th 529, 536, 30 Cal.Rptr.2d 286(*S.C.Anderson*).) " '[M]athematical precision' " is not required. (*Lewis Jorge, supra,* 34 Cal.4th at p. 975, 22 Cal.Rptr.3d 340, 102 P.3d 257.) Although lost profits damages due to diminished bonding capacity are not inherently speculative, "such damages are frequently denied as too ***115** speculative." (*Lewis Jorge, supra,* 34 Cal.4th at p. 975, 22 Cal.Rptr.3d 340, 102 P.3d 257; see also *Arntz Contracting Co. v. St. Paul Fire Marine Ins. Co.* (1996) 47 Cal.App.4th 464, 489, 54 Cal.Rptr.2d 888(*Arntz*) ["lost profit from impaired bonding capacity ... is not inherently speculative"].) "These cases bar recovery of profits lost on future contracts not because the amount of the lost profits is speculative or remote, but because their occurrence is uncertain." (*Lewis Jorge, supra,* 34 Cal.4th at p. 976, 22 Cal.Rptr.3d 340, 102 P.3d 257.)

Although the *Lewis Jorge* court noted that the contractor's purported lost profits were uncertain and speculative, the court's basis for reversing the lost profits damage award was lack of forseeability. (*Lewis Jorge, supra,* 34 Cal.4th at p. 977, 22 Cal.Rptr.3d 340, 102 P.3d 257.) "No court has adopted [the] position that damages for lost bonding capacity can be established only with proof of 'specific, identified construction projects that the contractor had prepared bids on, but was precluded from submitting because of an inability to obtain bid bonds.' " (*Arntz, supra,* 47 Cal.App.4th at p. 489, 54 Cal.Rptr.2d 888.)

While BEGL did not present evidence regarding specific projects or sums lost as a result of its impaired bonding capacity, it provided other evidence of lost profits. BEGL was started in 1987, and it began performing public works projects in 1995. Beglari testified that BEGL was bidding jobs until INSCO/DICO was notified about the dispute between Fidelity and BEGL in November 2002. Once that occurred, BEGL could no longer obtain bonding for public works projects.

BEGL's expert, Ashton Golbar, a certified public accountant, testified that from 1997 through 2001, BEGL had an average annual income of $433,000. BEGL bid on approximately 15 jobs while bonded by INSCO/DICO, and was awarded four or five of them. After reviewing all of BEGL's financial information from 1997 to the time of trial, Golbar testified that BEGL lost $506,000 in profits from November 2002 until the time of trial, November 2004, as a result of the loss of bonding capacity.

"Requiring [a contractor] to prepare detailed bids it could never submit would compel a senseless waste of time and provide no surer safeguard against speculative damages." (*Arntz, supra,* 47 Cal.App.4th at p. 489, 54 Cal.Rptr.2d 888.) Because the District has not provided any other reason why the lost profits damages in this case are speculative or uncertain, we affirm the award.

DISPOSITION

The judgment and orders are affirmed. Each party is to bear its own costs on appeal.

We concur: WILLHITE and MANELLA, JJ.

Mardirossian & Associates, Inc. v. Ersoff, 153 Cal.App.4th 257, 62 Cal.Rptr.3d 665 (2007).

Court of Appeal, Second District, Division 7, California.

MARDIROSSIAN & ASSOCIATES, INC., Plaintiff and Respondent,
v.
Seth ERSOFF, Defendant and Appellant; Philip A. Levy, Objector and Appellant.

No. B182966.

June 18, 2007.

***668** PERLUSS, P.J.

Seth Ersoff appeals from the judgment entered in this action in quantum meruit filed by his former legal counsel, Mardirossian & Associates, Inc. (M & A), to recover attorney fees. Ersoff asserts the trial court committed multiple errors before, during and after trial and contends the jury's special verdict is not supported by substantial evidence. * * * We affirm.

FACTUAL AND PROCEDURAL BACKGROUND

1. *The Infomercial Deal*

Ersoff managed the careers of Sugar Ray Leonard, the former Olympic boxing gold medalist and world champion, and Billy Blanks, a physical trainer who had developed an exercise program called Tae Bo. In March 1998 Ersoff entered a written agreement with Universal Management Services, Inc. (UMSI), an infomercial production company, and its president, Paul Monea, to create an infomercial marketing***669** Blanks's Tae Bo program. After Leonard gave Ersoff a videotaped testimonial for the Tae Bo tapes, Ersoff, purportedly on Leonard's behalf, signed Leonard's name to a testimonial release authorizing UMSI's use of the videotape for the infomercial under certain conditions. Under the terms of Ersoff's own agreement with UMSI, Ersoff would receive five percent of adjusted gross revenue from the Tae Bo infomercial. Within a few days of Ersoff's execution of the agreement with Monea and UMSI, Leonard notified UMSI that he did not wish the videotaped testimonial or his name to be used in connection with the infomercial.

2. *Ersoff Retains M & A To Prosecute His Claim in the Tae Bo Litigation*

Ersoff became concerned UMSI did not intend to honor its agreement to pay him a percentage of the profits generated by the infomercial sales. Accordingly, in August 1998 Ersoff asked M & A and, specifically Garo Mardirossian, the firm's named partner, to represent him in an action he wished to file against UMSI potentially involving, among other things, breach of contract, fraud and related tort claims. Ersoff, a law school graduate, told Mardirossian that Leonard wished to participate in the action and to sue UMSI for the unauthorized use of his name and likeness and to seek a temporary restraining order enjoining the broadcast of the infomercial. Ersoff suggested to M & A that Leonard's celebrity status would add value to the action by generating publicity and that a temporary restraining order prohibiting UMSI's use of Leonard's name and likeness would help forge a quick settlement, which Ersoff repeatedly informed M & A was his main objective in bringing the lawsuit.

M & A initially declined to take the case, concerned about a number of things, including the solvency of UMSI and Monea and the difficulty of obtaining any recovery even if Ersoff were to prevail. However, at Ersoff's repeated insistence, M & A agreed it would represent Ersoff at a 50 percent contingency fee if Mardirossian determined, after meeting with Leonard, that he could fairly represent both Ersoff and Leonard in the action. During a personal meeting with Leonard, Mardirossian advised Leonard that Leonard's involvement would generate publicity with Ersoff likely being the main beneficiary. Leonard replied he was participating in the action to assist Ersoff, he wished to pursue the action and the temporary restraining order primarily to help Ersoff and further communications to him about the case should be directed to Ersoff.

In November 1998 Ersoff signed a retainer agreement that provided M & A would take the matter on a contingency-fee basis and retain or claim “50% of any and all sums recovered on behalf of Client from any defendant and/or insurance company which may be paid or become due in settlement, or by judgment or otherwise. [¶] ... If recovery is not obtained, the Attorney will receive no fee." The retainer agreement further provided, "The Client hereby grants Attorney a lien upon the cause of action, and upon any document, records, or papers in connection therewith and upon any sum received to the extent of the foregoing fees and costs incurred or advanced. Said lien is based upon the reasonable value of Attorney's services valued at $400.00 per hour for Garo Mardirossian and $220.00 per hour for other attorneys of [M & A]. Or, Attorney may elect compensation based upon the agreed contingency for any offer to Client to settle the matter prior to the Attorney's discharge.... In the event Client discharges Attorney and/or chooses to terminate the claim, Client agrees to compensate Attorney pursuant to the ***670** hourly fee schedule set forth above for efforts expended by Attorney plus all costs advanced by Attorney on Client's behalf. If another attorney assumes responsibility for the file thereafter upon discharge, Client agrees to pay Attorney upon settlement or verdict the reasonable value of services performed by [M & A]. Attorney may elect compensation based upon the agreed contingency for any offer to Client received prior to attorney's discharge." Both Ersoff and Leonard signed separate documents expressly consenting to M & A's representation of them notwithstanding any conflicts of interest.[FN2]

FN2. The written consent Ersoff signed provided, "I, Seth Ersoff, with full knowledge, counsel and consent, free of any undue influence, do hereby agree to allow [M & A] to continue representing me in my case against Paul Monea, [UMSI] and any other person or entity I choose to pursue in connection with my dealings with Mr. Monea. Such dealings include but are not limited to the Billy Blanks' TAE BO Infomercial. I have separate counsel with whom I have been given an opportunity to consult regarding this matter. I realize there may be conflicts between my goals and those of Sugar Ray Leonard. If there are any such conflicts of interest, I waive them. [¶] I understand that I am entitled to full advocacy on my behalf and I believe that this will be accomplished by [M & A], whom I hereby give complete authority to represent me." Leonard signed a similar consent.

3. *Ersoff Terminates M & A and Nine Days Later Settles the Tae Bo Litigation*

On April 12, 1999, after M & A had filed a complaint against Monea and UMSI, worked on the case for seven months and prepared for Blanks's deposition scheduled for April 13, 1999 and for a mediation scheduled for April 21, 1999, Ersoff terminated M & A's representation and replaced it with the law firm of Wood, Smith Henning & Berman, where Ersoff's wife is a partner. At the April 21, 1999 mediation Ersoff received his first settlement offer from Monea and UMSI. Ersoff's case settled that day, with UMSI and Monea agreeing to pay Ersoff $3.7 million.

4. *M & A's Complaint Against Ersoff for Attorney Fees*

On November 7, 2002 M & A filed a lawsuit in the Los Angeles Superior Court (Case No. BC284854); [FN3] its operative first amended complaint asserts a single cause of action for quantum meruit seeking at least 50 percent of the $3.7 million settlement amount.

FN3. Initially, M & A's dispute with Ersoff was arbitrated. The arbitrator awarded M & A $1.5 million, which the trial court confirmed. On October 30, 2001 Division One of this court concluded the arbitration award must be vacated because Ersoff had not been properly advised of his right to nonbinding arbitration of attorney fee disputes in accordance with Business and Professions Code section 6201. (See *Ersoff v. Mardirossian & Associates, Inc.* (Oct. 30, 2001, B142063), 2001 WL 1337580 [nonpub. opn.].) Thereafter, Ersoff notified M & A of his intent to waive his right to arbitration and to litigate the dispute in the superior court.

5. *The Bifurcated Trial: Phase One*

In February 2004 the trial court granted Ersoff's motion to bifurcate two issues to be decided by the court prior to a jury trial: (1) whether the retainer agreement provided that the reasonable value of M & A's services in the event of a discharge prior to the receipt of a settlement offer ***671** was to be measured solely by multiplying the hours the firm spent on the case by the hourly billing rates of the attorneys who worked on the case ($400 for Mardirossian and $220 for his associates) and (2) whether an actual conflict of interest existed between Ersoff and Leonard as to which Ersoff could not, as a matter of law, give his informed consent; and if so, whether M & A's simultaneous representation of both Ersoff and Leonard in the underlying action against UMSI and Monea violated rule 3-310 of the California Rules of Professional Conduct (rule 3-310) and required forfeiture of any right to attorney fees as a matter of law. (See, e.g., *Huskinson & Brown v. Wolf* (2004) 32 Cal.4th 453, 463, 9 Cal.Rptr.3d 693, 84 P.3d 379 [when attorney violates rules of professional conduct by engaging in simultaneous and conflicting representation without obtaining sufficient informed consent, quantum meruit recovery to collect fees may be prohibited under certain circumstances]; *Goldstein v. Lees* (1975) 46 Cal.App.3d 614, 618, 120 Cal.Rptr. 253 [quantum meruit recovery found inappropriate when former corporate counsel labored under a conflict of interest in representing a minority shareholder and director of his former client in a proxy battle in violation of predecessor rule to rule 3-310].)

Following the presentation of testimony and other evidence on the bifurcated issues, the trial court ruled the retainer agreement was unambiguous: When, as here, there had been no settlement offer prior to its discharge, the agreement contemplated M & A would receive the reasonable value of its services as measured by multiplying a reasonable number of hours spent on the case by the attorneys' hourly rates. The court further ruled it was for the jury, as the finder of fact, to determine in the next phase of the proceeding the number of hours Mardirossian and his associates actually worked on the matter and whether that number of hours was reasonable.

The trial court rejected Ersoff's contention that, by simultaneously representing both Ersoff and Leonard in the underlying litigation against UMSI and Monea, M & A had violated rule 3-310 and thus forfeited its right to attorney fees as a matter of law. The court concluded there existed, at most, a potential conflict of interest between Ersoff's and Leonard's interests in the litigation and the consent form Ersoff had executed was sufficient and valid for the potential conflict that existed during the relevant period. The court further found no prejudice to Ersoff as a result of the dual representation.

* * *

***672** 7. *The Trial: Phase Two*

a. *Ersoff's motions in limine*

* * *

The trial court granted in part and denied in part Ersoff's motion in limine to exclude evidence of the settlement amount in Ersoff's case against Monea and UMSI, permitting evidence of the settlement amount to be disclosed to the jury only to the extent [M & A's expert witness, contingency fee attorney Dana] Hobart relied on it in forming his opinion whether the hours M & A had spent on the case were reasonable. Evidence of the amount of M & A's prior arbitration award was excluded.

b. *The trial testimony of M & A's attorneys*

At trial Mardirossian and three of his associates during the relevant period, Joseph Barrett, Donald Conway and Kathy Mardirossian, testified that, as contingency fee attorneys, they kept no time sheets but could recall the number of hours they worked in total during the relevant period and could fairly estimate the percentage of their work time spent on Ersoff's case. Each testified as to the work he or she specifically accomplished for Ersoff:

Barrett testified that, between August 1998 and April 11, 1999, Ersoff's case was the major matter in the office and Barrett's primary case for that time period. He met or spoke with Ersoff almost daily and explained there were a number of ***673** difficult issues in the case that he had to research and resolve including UMSI's rescission claims based on allegations of Ersoff's fraud, UMSI's solvency, receivership issues and difficulty tracking sales from the infomercial. He testified he worked 60 hours per week for Mardirossian during the period August 1998 to April 11, 1999 and estimated 60 percent of that time was spent on Ersoff's case. He also testified that, in late April 1999, he began preparing a written summary of the work he had performed on the case at the request of Ersoff's new firm, but stopped when it appeared an agreement had been reached. The 13 page summary, which details, week by week, the work Barrett states he performed for Ersoff (but does not include a reference to the hours spent), was admitted into evidence without objection.

Conway explained the Ersoff case was also the primary matter that occupied his time from September 1998 until the middle of April 1999 and that he and Barrett worked closely together on every matter in the case. He, like Barrett, was personally involved in drafting or assisting on every one of the pleadings and the unsuccessful attempt to obtain a temporary restraining order against UMSI. Conway also testified at length as to the receivership issues he worked on with associated counsel and explained that additional work was required when it came to light that Ersoff had made representations to UMSI that he did not disclose to M & A until well into the litigation. According to Conway's estimates, he worked 50 to 60 hours a week from August 1998 to April 11, 1999 and spent two-thirds of that time working on Ersoff's case in 1998 and one half that time working on Ersoff's case in 1999, for a total of approximately 1020 hours.

Kathy Mardirossian testified she worked five to six hours a week for approximately 40 weeks participating in every meeting and strategy session and assisting in drafting pleadings and discovery in the action. She explained this was a conservative estimate and that she took pains to review the file and to discuss the work she performed on the case with the other associates and with Mardirossian to ensure there was no duplication of effort.

Garo Mardirossian testified he worked 60 hours a week from August 1998 to April 11, 1999 and spent approximately 50 percent of that time on Ersoff's case in various capacities, less the four weeks he worked exclusively on another trial. He explained he participated in every meeting, met with Ersoff and his associates and reviewed every pleading and all correspondence that was drafted in regard to the case.

c. *Expert testimony*

Expert testimony as to whether the number of hours claimed by M & A was reasonable was also presented by both M & A and Ersoff. Testifying as an expert for M & A, Hobart explained, based on his review of the files in the underlying case, as well as all of the pleadings and deposition testimony in the instant case and the multimillion dollar settlement amount, it was reasonable for M & A to have worked approximately 3,700 hours on the matter. He explained that, because contingency fee lawyers' fees depend on the outcome, they often spend many more hours than an hourly attorney would on a case, unconcerned about the mounting hours because the client will not be billed. He also explained the number of hours cannot be determined solely from looking at the tangible work product in the file, such as the pleadings and discovery. In light of the $3.7 million settlement, achieved just days after M & A was substituted out of the case, with little or no additional work accomplished by the firm that substituted ***674** in for M & A and the complexity and number of issues involved in the case, Hobart opined that it was not unreasonable for M & A to have put in 3,700 hours worth of work leading up to the eventual settlement in the action.

Alan Jay Weil, an attorney who does not take cases on contingency, testified as an expert for Ersoff. Weil opined that it was preposterous for any firm to have spent 3700 hours on this case. Based upon the work product in the file in the underlying case, Weil opined that, at most, a reasonable attorney would have spent no more than 200 hours preparing the case from August 1998 to April 11, 1999.

d. *The jury's verdict and entry of judgment*

In its special verdict the jury found M & A had reasonably spent 2,392 hours on Ersoff's case: Mardirossian had reasonably spent 540 hours on Ersoff's case and M & A associates Conway, Barrett and Kathy Mardirossian had reasonably spent 960 hours, 890 hours and 102 hours, respectively. In accordance with the court's instructions to multiply the hours by each attorney's hourly rate, the jury awarded M & A $645,440. Following the jury's verdict, the court ordered statutory prejudgment interest be added to the verdict amount from the date the complaint had been filed (November 7, 2002) until the date the amount is paid. Judgment was entered on April 6, 2005.

CONTENTIONS

Ersoff contends (1) the trial court erred in denying his motions in limine to exclude evidence of the number of hours the M & A attorneys worked on Ersoff's case and expert testimony as to whether the claimed hours were reasonable; (2) there is no substantial evidence to support the jury's verdict; (3) prejudgment interest is improper in a quantum meruit action; (4) the jury instructions and special verdict forms were erroneous and resulted in a miscarriage of justice;(5) the court erred in denying Ersoff's motion to dismiss M & A's action for lack of standing; and (6) the court erred in imposing monetary sanctions against him. Ersoff's counsel, Philip Levy, also challenges the sanctions order against him.

DISCUSSION

1. *The Court Did Not Err in Denying Ersoff's Motions in Limine*

[*This part of the opinion has been redacted.*]

* * *

***678** 2. *Substantial Evidence Supports the Jury's*

Verdict as to the Number of Hours Expended

Although Ersoff frames his argument on appeal as a challenge to the trial court's rulings on the motions in limine, his appellate brief cites to testimony actually provided during phase two of the trial. In effect, Ersoff's challenge to the in limine rulings "is really one of insufficient evidence to support the court's judgment. As such, it fails since all hours allegedly worked by counsel for which no time records were available were attested to by the attorneys under oath. The problem then becomes one of fact finding" (*Margolin v. Regional Planning Com.* (1982) 134 Cal.App.3d 999, 1006-1007, 185 Cal.Rptr. 145 [considering reasonable attorney fee award under private attorney general statute, Code Civ. Proc., § 1021.5]) and accordingly, for this reviewing court, whether the fact finder's conclusions are supported by substantial evidence. * * *

Although Ersoff suggests the attorneys' time estimates amounted to nothing more than guesses without any present recollection by the M & A attorneys of the hours spent, the record shows otherwise. Each of the M & A attorneys who worked on Ersoff's case testified in detail as to the work he or she had performed for Ersoff. Although the attorneys explained they could not remember six years after the ***679** fact the amount of time spent on each item for which they had labored on Ersoff's behalf, the attorneys explained they remembered the amount of work accomplished during the period and could provide fair weekly estimates of their time by recalling the percentage of their work week spent on Ersoff's case. Each provided specific testimony on the work he or she performed individually for Ersoff, discussed the complexity of the issues in a multi-million dollar case and explained the obstacles faced and the hours spent in preparing the matter for trial. Ersoff's counsel vigorously cross-examined each witness as to the items he or she had worked on and argued to the jury the estimates were inexact and totally disproportionate to the amount of work product created for the case. Expert witnesses on both sides testified concerning the reasonableness of the time spent in light of the nature of the case and the complexity of the issues presented. There was also evidence presented to the jury that the law firm that replaced M & A itself spent a total of 400 to 500 hours in the nine days leading up to the mediation simply to become familiar with the issues in the case-that is, without performing any additional work. The jury found that M & A did spend a great deal of time on the case-2,392 hours-albeit far less (less than two-thirds) than the approximately 3,800 hours testified to by the M & A attorneys. Based on the testimony at trial, the jury's verdict is amply supported by substantial evidence. * * *

3. *Neither the Challenged Jury Instruction nor the Special Verdict Was Improper*

a. *The challenged jury instruction*

[17] The jury was instructed, "The plaintiff law firm was not required to maintain time records, nor to bill the client monthly or at all for the legal services rendered to defendant Seth Ersoff." Ersoff contends, even if evidence of billing records is not required to support a claim for attorney fees, Business and Professions Code section 6148, subdivision (b), mandates they be maintained. He insists the instruction suggesting otherwise was erroneous.

As Ersoff contends, Business and Professions Code section 6148, subdivision (b), provides, "All bills rendered by an attorney to a client shall clearly state the basis thereof. Bills for the fee portion of the bill shall include the amount, rate, basis for calculation, or other method of determination of the attorney's fees and costs." However, subdivision (a) of section 6148, which Ersoff fails to cite, states its provisions do not apply to any case coming with Business and Professions Code section 6147, pertaining to contingency fee agreements. Section 6147, in turn, requires a statement of the contingency fee rate, but does not require contingency fee lawyers ***680** to maintain billing records. In addition, Ersoff's argument omits reference to subdivision (c) of section 6148, which makes clear that, even when the section applies and has been violated, an attorney is still "entitled to collect a reasonable fee." (See Bus. & Prof.Code, § 6148, subds. (b), (c); see also *Flannery v. Prentice* (2001) 26 Cal.4th 572, 579, 110 Cal.Rptr.2d 809, 28 P.3d 860 [when Bus. & Prof.Code, § 6148, subd. (b), is violated, attorney still entitled to collect reasonable fee as provided in subdivision (c) of that section].) FN10

> FN10. Similarly, when a contingency fee lawyer violates the requirements for a contingency fee agreement set forth in Business and Professions Code section 6147, subdivision (a), Business and Professions Code, section 6147, subdivision (b), provides, "Failure to comply with any provision of this section renders the agreement voidable at the option of the plaintiff, and the attorney shall thereupon be entitled to collect a reasonable

fee."

* * *

***681** b. *Special verdict form*

[*This part of the opinion, in which the court held the special verdict form was not prejudicial, has been redacted*.]

4. *The Trial Court Did Not Err in Awarding Prejudgment Interest*

[*This part of the opinion, not certified for publication, has been redacted*.]

* * *

5. *The Trial Court Did Not Commit Prejudicial Error in Phase One When It Found M & A Was Not Prohibited from Recovering Fees in Quantum Meruit*

Rule 3-310(C) prohibits an attorney from simultaneously representing more than one client in a matter in which the interests of the clients potentially or actually conflict in the absence of the clients' informed written consent. Ersoff contends M & A violated rule 3-310 when it simultaneously represented Ersoff and Leonard in their action against UMSI and Monea. According to Ersoff, a conflict existed at the inception of the dual representation because Ersoff had signed Leonard's name to the testimonial release authorizing UMSI's use of Leonard's testimonial for the infomercial, but Ersoff and Leonard apparently claimed in the litigation that Ersoff did not have the authority to sign Leonard's name. Also, Leonard sought (albeit unsuccessfully) a temporary restraining order that, if granted, would have interfered with Ersoff's interest in having the infomercial broadcast. As a result of these "egregious conflicts" and ***682** the failure to obtain sufficient informed consent, Ersoff argues the trial court erred in ruling M & A had not forfeited its right to recover attorney fees.

In certain circumstances, a violation of the Rules of Professional Conduct may result in a forfeiture of an attorney's right to fees. (See *Huskinson & Brown v. Wolf, supra,* 32 Cal.4th at p. 463, 9 Cal.Rptr.3d 693, 84 P.3d 379 [when attorney violates rule of professional conduct by engaging in simultaneously conflicting representation without sufficient informed consent, quantum meruit recovery to collect fees may be prohibited]; see also *Cal Pak Delivery, Inc. v. United Parcel Service, Inc.* (1997) 52 Cal.App.4th 1, 14, 60 Cal.Rptr.2d 207, fn. 2 ["The rule that an attorney who engages in conflicting representation without obtaining informed consent is not entitled to compensation is not based on the premise that the attorney must pay a penalty so much as the principle that 'payment is not due for services not properly performed'"].) Although the breach of a rule of professional conduct may warrant a forfeiture of fees, forfeiture is not automatic but depends on the egregiousness of the violation. (*Pringle v. La Chapelle* (1999) 73 Cal.App.4th 1000, 1005-1006, 87 Cal.Rptr.2d 90 [neither the Bus. & Prof.Code nor the Rules of Prof. Conduct provide for deprivation of fees whenever rule of professional conduct is violated; whether forfeiture of the right to collect fees is required depends on the egregious nature of the violation].)

* * *

In the instant case, after hearing extensive testimony and finding Leonard's objective was not to prohibit the use of his image but to be paid for it and to assist Ersoff's own action, the trial court concluded that, at most, a potential conflict of interest existed between the two men. It concluded the written consent informing Ersoff a conflict might exist, in which Ersoff expressly acknowledged the opportunity to consult outside counsel concerning the issue, was sufficient to comply with rule 3-310. In any event, the court ruled, any violation of rule 3-310 was not sufficiently egregious under the circumstance to justify a total forfeiture of fees. The court rejected Ersoff's analysis, namely, that as the person who signed Leonard's name to the release, there existed at the inception of the litigation an actual conflict of interest between Leonard and Ersoff, finding Ersoff had withheld this information from his attorney. The court explained, "If I were to excuse the requirement that Mr. Ersoff pay, I would be rewarding Mr. Ersoff for hiding conflicting information from his attorney. And it would be, I believe, a bizarre result." The court further concluded that, in light of M & A's work on Ersoff's behalf up until the mediation, "there would be an unjust enrichment of Mr. Ersoff if I would excuse the payment of attorney's fees."

***683** Ersoff does not challenge these factual findings on substantial evidence grounds. Instead, he asserts that rule 3-310 was violated because, even if the conflict were potential rather than actual, the written consent did not detail the conflicts at issue. As a result, he asserts, the consent is inadequate and M & A should be denied any fees. Yet, the adequacy of the written disclosure and consent is not dispositive. As the court observed, even if rule 3-310 were violated in this instance, Ersoff has not shown the violation was particularly egregious or that he was in any way prejudiced by it. Under the circumstances, we cannot say the trial court abused its discretion in concluding it would be inequitable and an "an unjust enrichment" if Ersoff's attorney fee obligation were to be excused. (*Sullivan v. Dorsa, supra,* 128 Cal.App.4th at p. 966, 27 Cal.Rptr.3d 547; *Pringle v. La Chapelle, supra,* 73 Cal.App.4th at pp. 1005-1006, 87 Cal.Rptr.2d 90 [where attorney represented corporation and employee in sexual harassment case in violation of rule 3-310, client failed to show how conflict of interest was sufficiently egregious to justify forfeiture of earned fees]; see also *Cal Pak Delivery, Inc. v. United Parcel Service, Inc., supra,* 52 Cal.App.4th at p. 16, 60 Cal.Rptr.2d 207 [acknowledging quantum meruit recovery may be proper despite attorney's violation of ethical rule "on an unjust enrichment theory where the client's recovery was a direct result of the attorney's services"].)

6. *The Trial Court Did Not Err in Denying the Motion To Dismiss and Imposing Sanctions*

[*This part of the opinion, not certified for publication, has been redacted*.]

* * *

DISPOSITION

The judgment is affirmed. M & A is to recover its costs on appeal.

JOHNSON and ZELON, JJ., concur.

Lu v. Grewal, 130 Cal.App.4th 841, 30 Cal.Rptr.3d 623 (2005).

Court of Appeal, Second District, Division 7, California.

Ai Ping LU, Plaintiff and Appellant,
v.
Ravinder S. GREWAL et al., Defendants and Respondents.

No. B173008.

June 28, 2005.
Review Denied Sept. 28, 2005.

****624 *845** ZELON, J.

Plaintiff and appellant Ai Ping Lu (appellant) appeals from a judgment in favor of defendants and respondents Narinder Singh Grewal and Ravinder S. Grewal (respondents) following a bench trial. Lu sued the Grewals for unpaid rent and other damages as a result of the breach of a commercial lease when respondents abandoned the subject property. The trial court entered judgment for respondents in spite of their breach, finding the appellant suffered no damages because she and her husband occupied the premises, managed to run the business at a profit, and mitigated damages well above the amount of damages owed by respondents.

Appellant contends, among other things, (1) the purpose of Civil Code section 1951.2 is to encourage productive use of vacant commercial property after abandonment, (2) section 1951.2 contemplates mitigation only in terms of efforts to relet the vacant premises, and (3) at the very most, respondents were entitled to an offset measured by the property's reasonable market rental value. For the reasons discussed hereafter, we conclude appellant is entitled to recover ****625** damages with mitigation based on the fair market rental value of the property. Accordingly, we reverse and remand for further proceedings in accordance with the views hereafter expressed.

FACTUAL AND PROCEDURAL BACKGROUND

The following factual background was not in dispute. In July 1993, respondent Narinder Singh Grewal, as lessee, entered into a written lease for a gas station located at 2050 West Manchester Boulevard in Los Angeles. Respondent Ravinder S. Grewal, brother of Narinder, was the guarantor of payment obligations under the lease. The 10-year lease commenced July 1, 1993, and expired June 30, 2003. Rent was $5,000 per month the first year, $5,500 per month the second year, and each year thereafter (years 3 through 10) the monthly rent was "increased by a flat 5% over the monthly installment paid during the previous 12 month period."

In June 1997, Narinder Grewal assigned the lease to Mepco Oil, Inc. The written Assignment of Lease did not release respondents from their original obligations under the lease.

***846** In August 2000, appellant purchased the gas station and adjacent service bays for $786,625. The business was incorporated under the name China Petrol Inc. and appellant was sole shareholder, director and officer. Appellant received only one rental payment for September 2000 from Mepco Oil. Thereafter no rent was paid either by respondents or Mepco Oil. In October 2000, appellant's husband George Beliciu discovered Mepco Oil was gone. The premises had been vandalized; gas pumps had been removed leaving only holes in the ground filled with gasoline. Computer controls for underground tanks were ripped out of the walls, wires had been cut, a point-of-sale computer was missing and everything inside the convenience store was missing, broken or moved.

Faced with property that was vacant, damaged and unproductive, appellant and her husband occupied the property, made necessary repairs, and began to operate the business themselves. Her husband became the manager and both worked at the business operating (except for one brief period) 24 hours a day, seven days a week, "practically sleeping in the gas station." Appellant claimed no profit was made the first three months but later the business began generating a profit. Appellant continued to attempt to relet or sell the property. ARCO and Exxon oil companies, among others, were contacted to see if there was any interest but declined to lease the property.

In early 2001 and again in 2002, appellant signed two listing agreements for the sale of the property. Appellant entered into escrow to sell the property for $1.45 million on October 19, 2002, but the sale did not close.

The lease, under Article 10.1, required

respondents to "maintain the subject premises and every part thereof, structural and non-structural, in good order and repair, whether or not the need for repair and maintenance occurs as the result of Lessee's use, any prior use, the elements, or the age of the premises."

Further, Article 11.1 provided that "Lessee shall indemnify and hold Lessor and Lessor's property harmless from and against any and all claims and related ****626** expenses arising from or related to Lessee's use of the subject premises, or from the conduct of Lessee's business or from any activity or work performed or permitted by Lessee or Lessee's employees and agents, at the subject premises or elsewhere, and ... Lessee hereby assumes all risk of property damage and personal injury on or about the subject premises arising from any cause and hereby waives all claims in respect thereof against Lessor."

***847** Appellant filed a claim for breach of the lease on October 7, 2002. Appellant operated the business throughout the remainder of the lease period and continued to do so up to the time of trial. A first amended complaint (FAC) was filed July 23, 2003, shortly after expiration of the lease term. The FAC stated causes of action for breach of contract including unpaid rent plus late charges, other specified damages, and damages resulting from removal of property and fixtures from the premises. Appellant also sought declaratory relief to establish respondents' breach and liability for damages. Respondents filed an answer asserting a general denial and setting forth five affirmative defenses: failure to state a cause of action, comparative negligence, waiver, failure to mitigate and unclean hands. Respondents argued appellant could not recover damages if she received more revenue from operating the premises than she would have under the lease.

At trial, respondents admitted the property had been abandoned during the lease term and that no rental payments were made over a period of several years. The only issue involved the amount of damages that was recoverable. Appellant presented evidence showing unpaid rent and late fees from October 2000 to June 30, 2003. Respondents did not dispute appellant's damages of unpaid rent; instead, they claimed a setoff based on mitigation pursuant to Civil Code section 1951.2. Appellants asserted that fair market rental value was the proper measure of mitigation; respondents contended that mitigation could properly be based on either operational profits or increased value as demonstrated by sale valuation.

At trial, appellant presented evidence of the property's fair market rental value by way of expert testimony from Alan Wallace, an attorney and real estate broker, and Scott Olson, a real estate broker specializing in the sale of gas stations. Although Mr. Olson was originally contacted by respondents' attorney to provide a lease value for the property, he was subpoenaed by appellant and testified that he inspected the property, looked at comparable leases, obtained a property profile from a title company and based on his knowledge of the industry concluded the property had a fair market rental value of $5,500 a month. Respondents presented no testimony concerning rental value; instead their expert, CPA Jason Engel, made assumptions concerning operations in order to conclude that profits generated during the period of time from approximately October 2000 to June 2003 far exceeded any lease obligation. His testimony, in large part, was critical of and responsive to the analysis prepared by appellant's expert, CPA Barry Charles, that in turn was designed to meet respondents' mitigation theory.

***848** The trial court chose to adopt the theory suggested by respondents that appellant fully mitigated her damages by deriving a profit from the operation of her business ****627** despite respondents' breach. The trial court held "[a]ny damages by reason of the breach of the lease were far less than the profits made by [appellant] and her husband, from the operation of the gas station and minimarket after the breach of the lease during the lease period. [¶] As such, judgment is entered on behalf of [respondents] with attorney's fees and costs in favor of [respondents] to be determined." Appellant was denied relief altogether and respondents were awarded costs and legal fees in the amount of $214,322.36.

Appellant filed a timely notice of appeal from the judgment and post-judgment award of costs and attorney fees.

DISCUSSION

1. Standard of review

The facts relevant to the issues that must be determined on this appeal are undisputed. Rather, this appeal involves interpretation of statutory law, in particular the application of Civil Code section 1951.2 to this case. Matters of interpreting and applying statutes are questions of law. We therefore review de novo the judgment entered below. (*Ghirardo v. Antonioli* (1994) 8

Cal.4th 791, 799, 35 Cal.Rptr.2d 418, 883 P.2d 960.)

2. Civil Code section 1951.2

In 1970, the California legislature enacted section 1951.2 to address the issue of a landlord's rights and remedies in response to a tenant's abandonment of the property. Under the common law in effect prior to the enactment, the breach of the lease, if treated as a termination, ended the lessee's obligation to pay rent, forcing a lessor to abandon its claim. If the lessor opted not to terminate, the choices were also limited: sue on each monthly rental payment as it came due; or re-lease for the benefit of the tenant. Section 1951.2 provides that abandonment of the premises results in de facto termination of the lease. This automatic termination of the lease converts a landlord's continuing right to rent under the lease into a damage claim for rent lost through the tenant's abandonment.

Section 1951.2 also governs the amount which a lessor may receive in damages from a lessee who breaches a lease as follows: "(1) The worth at ***849** the time of award of the unpaid rent which had been earned at the time of termination; [¶] (2) The worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that the lessee proves could have been reasonably avoided; [¶] ... [¶] (4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessees failure to perform [its] obligations under the lease or which in the ordinary course of things would be likely to result therefrom."

Here, it is undisputed that the property was abandoned during the lease term in October 2000 and that no rental payments were made for the remaining term. At trial, respondents claimed, and the trial court agreed, respondents were entitled to full mitigation credit for the profits generated by appellant's operation of her business thereby offsetting any award due appellant. Appellant contends, however, the correct measure for mitigation credit is the property's fair market rental value. We agree.

****628** 3. Mitigation of Damages in this case

In an action for breach of contract, the measure of damages 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" (§ 3300), provided the damages are "clearly ascertainable in both their nature and origin." (§ 3301.)

Under section 1951.2, a lessor may recover damages only to the extent unpaid rent exceeds "the amount of such rental loss that the lessee proves could have been reasonably avoided." (§ 1951.2, subd. (a)(2), (a)(3) and (c)(1).) The rationale for this law, changing the ability of a lessor to recover damages in the event of a lessee's breach, was to permit recovery in a more straightforward manner than prior common law permitted. While simplifying recovery, however, the Legislature recognized that a lessee should be credited with amounts that could have been obtained on a reasonable attempt to re-lease the property. Accordingly, "the basic measure of the lessor's damages should be made the loss of the bargain represented by the lease--*i.e.* the amount by which the unpaid rent provided in the lease exceeds the amount of rental loss that the lessee proves could have been or could be reasonably avoided." The burden of proof rests with the lessee: "In determining the amount recoverable under paragraphs (2) and (3) of subdivision (a), the lessee is entitled to have offset against the unpaid rent not merely all sums the lessor has received or will receive by virtue of a reletting of the property which has actually been accomplished but also all sums that the lessee can *prove* the lessor could have obtained or could obtain by acting ***850** reasonably in reletting the property. The duty to mitigate the damages will often require that the property be relet at a rent that is more or less than the rent provided in the original lease. The test in each case is whether the lessor acted reasonably and in good faith in reletting the property." (Cal. Law Revision Com., Recommendation--Real Property Leases, p. 164.)

"A plaintiff cannot be compensated for damages which he [or she] could have avoided by reasonable effort or expenditures.... The doctrine does not require the injured party to take measures which are *unreasonable or impracticable* or which would involve expenditures disproportionate to the loss sought to be avoided or which may be beyond his [or her] financial means." (*Green v. Smith* (1968) 261 Cal.App.2d 392, 396-397, 67 Cal.Rptr. 796; emphasis added.)

Further, the measure of appellant's recoverable damages is not limited to damages for loss of rent. Appellant is also entitled to any other damages caused by the breach. "As the legislative committee comment to [section 1951.2] makes clear, the lessor, in addition to lost rent, is entitled to 'all of the other damages a person is entitled to recover for the breach of a contract....' Thus, [appellant] is entitled to any other damages caused by the breach ... and *any other special damages* incurred as a proximate result of the breach." (*Sanders Construction Co. v. San Joaquin First Fed. Sav. & Loan Assn.* (1982) 136 Cal.App.3d 387, 401, 186 Cal.Rptr. 218; emphasis added.) Hence, appellant may seek unpaid rent and consequential damages, namely "the full benefit of its bargain." (*Id.* at p. 402, 186 Cal.Rptr. 218.) For example, to the extent appellant would not have had to incur such expenses had respondents performed under the lease, appellant is entitled to reasonable expenses in retaking possession of the property, in making repairs respondents ****629** were obligated to make, in preparing the property for reletting, and damages for breach of specific covenants of the lease--a promise to maintain or restore the premises upon termination of the lease.

Several courts have dealt with mitigation under section 1951.2 in terms of reletting the abandoned property. No California court, however, has approved the profit based measure of mitigation applied in this case. Here, appellant restored the property and devoted substantial efforts to running a business there to avoid the wasteful prospect of leaving the property unattended and unproductive. Although she made efforts to re-lease the premises, they were unsuccessful. As a result appellant's damages are the loss of the bargain represented by the lease (i.e. $5,500 per month plus an additional five percent each year for years 3 through 10) plus any consequential damages proved ***851** to the court, less any amount in mitigation that lessee proved. [FN5] (*Willis v. Soda Shoppes of California, Inc.* (1982) 134 Cal.App.3d 899, 905, 184 Cal.Rptr. 761.)

> FN5. In fact, lessee presented no evidence of fair market rental value. Moreover, the court erred in imposing the burden of proof as to mitigation on appellant, rather than respondent.

Respondents are not entitled to the benefit of appellant's hard work and capital in making the property productive; nor should appellant be punished for bringing the abandoned property back to life. An owner of commercial real property is not required, by virtue of a tenant's breach, to run the business located there at the expense of using time and capital to run a business elsewhere. A tenant has an interest neither in the value of the land, nor in the value of the landowner's business ventures. A tenant's right not to pay damages for rent that he proves could have been earned had the property been re-leased at fair market value does not convert a landowner's ability--or inability--to successfully run a business into an offset against the tenant's breach. And, just as a landlord, after the enactment of section 1951.2, has no obligation to re-lease the property for the benefit of the tenant to recover lost rent, that landlord has no obligation to run the business on the property for the tenant's benefit.

The contrary interpretation, upon which the trial court relied for its decision, defies principles of public policy and offends notions of fairness, justice and common sense. "Statutes are to be interpreted so as to avoid absurd results.... [T]he legislative scheme [of section 1951.2] is ... to engraft the contract remedy of loss of bargain onto real property law." (*California Safety Center, Inc. v. Jax Car Sales* (1985) 164 Cal.App.3d 992, 999, 211 Cal.Rptr. 39.)

For the same reason, evidence introduced by respondents concerning appellant's unsuccessful attempts to sell the property could not properly be considered as an offset. Respondents' damages expert argued that those attempts demonstrated an increase in value that proved no damage resulted from the breach. Even if a sale had been completed, however, any profit on that sale would not reduce the damages attributable to the breach. A breaching tenant cannot claim an interest in the value of the property itself--a value its lease never entitled it to profit from--to avoid the consequences of its own breach. "We hold, therefore, that sale of the property by the landlord following the tenant's abandonment of a lease does not deprive the landlord of its available contract remedies under section 1951.2. The landlord retains the right under section ****630** 1951.2 to claim rental loss accruing after the date of sale, except to the extent the breaching tenant can prove the rental loss was avoidable, together with consequential damages under subdivision (a)(4) under standard contract principles." (*Millikan v.* ****852*** *American Spectrum Real Estate Services California, Inc.* (2004) 117 Cal.App.4th 1094, 1104, 12 Cal.Rptr.3d 459.)

Because we find the trial court erred in not considering fair market rental value as the appropriate mitigation measure, and erred in allocating the burden of proof, it is highly probable that appellant would have received a more favorable judgment had the proper standard been applied.

We further find that the matter should be remanded to the trial court only for the purpose of a determination of damages in accordance with Civil Code section 1951.2. On remand, the burden of proof rests with respondent: "[Section 1951.2] makes clear that the *lessee* has the burden of proving the amount he [or she] is entitled to have offset against the unpaid rent." (§ 1951.2, Legis.Com.Comment.)

****853** DISPOSITION*

The judgment is reversed and remanded to the trial court in light of our determination appellant was entitled to damages for unpaid rent (applying the fair market rental value standard for mitigation purposes) and for consequential damages. The post judgment order granting costs and legal fees to respondents is reversed. On remand the court is to determine who is the prevailing party. Appellant is awarded costs on appeal.

We concur: PERLUSS, P.J., and JOHNSON, J.

Harbor Island Holdings, LLC v. Kim, 107 Cal.App.4th 790, 132 Cal.Rptr.2d 406 (2003).

Court of Appeal, Fourth District, Division 3, California.

HARBOR ISLAND HOLDINGS, L.L.C., Plaintiff and Appellant,
v.
James Y. KIM et al., Defendants and Respondents.

No. G030264.

April 2, 2003.

***793 **407** OPINION

MOORE, J.

A landlord, displeased with its tenant, reluctantly agreed to a lease extension requiring greatly increased rental payments. The landlord demanded one price if the tenant complied with the lease agreement in every regard and double that amount in the event of any breach. After the conclusion of the extended lease term, the landlord sued the tenant, seeking both damages occasioned by the tenant's failure to properly maintain the premises, plus nearly a quarter of a million dollars for the doubled rent. The trial court awarded damages for the failure to maintain the property, but held the lease provision for the doubled rent was unenforceable as a penalty. The landlord appeals. We agree with the trial court's reasoning and affirm.

I
FACTS

Harbor Island Holdings, L.L.C. (Harbor Island) leased certain commercial property, located in Torrance, California, to E & J Textile Group, Inc. (E & J) and James Y. Kim (Kim). The original lease term was from July 1, 1996 through June 30, 1999. E & J and Kim had contemplated moving to new premises at the end of the original lease term. However, the construction of the new premises was not completed on time, so they sought a lease extension. On March 31, 1999, the parties agreed to a three-month extension, ending September 30, 1999.

Under the original lease, the rent was $30,974.40 per month. The rent jumped to $96,364.80 per month under the lease amendment. Under the amendment, half of the monthly rent, or $48,182.40, would be conditionally "deferred" and ultimately forgiven if E & J and Kim complied with all of their obligations under the amended lease.

E & J and Harbor Island agreed to extend the lease for another two months. E & J vacated the premises on November 30, 1999.

Harbor Island filed suit against E & J and Kim. Among other things, it alleged E & J and Kim had breached their obligation to maintain and repair the premises. It also alleged they had failed to pay base rent in the amount of $240,912. This amount was equal to $48,182.40 per month for the period of July 1, 1999 through November 30, 1999 – a recapture of the deferred portion of the monthly rent that Harbor Island had not forgiven at the end of the extended lease term. The complaint listed causes of action for breach of ***794** lease and ****408** quantum meruit..

E & J and Kim filed a cross-complaint, seeking the return of their security deposit. They later filed a motion for summary adjudication of issues. Among other things, they argued the deferred rent provision was illegal as a penalty, and therefore unenforceable. The motion was denied as to that issue.

Pursuant to the special verdict, the jury found that E & J and Kim had failed to maintain or repair the leased premises in accordance with the lease provisions. It further found that the damage to Harbor Island on account of this breach was $13,970. In addition, the jury found that Harbor Island had breached the lease by failing to return the security deposit to E & J and Kim. The amount of the security deposit was $48,182.40. The jury concluded that E & J and Kim had been damaged in the amount of $37,633.60. That amount was equal to the $48,182.40 security deposit minus the $13,970 in damages for the failure of E & J and Kim to maintain or repair the premises, plus prejudgment interest.

Judgment in the amount of $37,633.60, plus interest, attorney fees and costs, was entered in favor of E & J and Kim. Harbor Island appealed.

II
ANALYSIS

* * *

C. Civil Code Section 1671

The validity of the deferred rent provision is determined under Civil Code section 1671. Subdivision (b) thereof provides: "[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 ***796** provision was unreasonable under the circumstances existing at the time the contract was made."

Our Supreme Court has enunciated standards for the application of Civil Code section 1671. In *Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th at p. 977, 73 Cal.Rptr.2d 378, 953 P.2d 484, it stated: "A liquidated damages clause will generally be considered unreasonable, and hence unenforceable under section 1671[, subdivision] (b), if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. The amount set as liquidated damages 'must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained.' In the absence of such relationship, a contractual clause purporting to predetermine damages 'must be construed as a penalty.'"

Here, the original base rent was in the amount of $30,974.40 per month. Under the lease extension, the monthly rent became $48,182.40, so long as E & J and Kim complied with all of their obligations under the amended lease. This was an increase of more than 55 percent. If E & J and Kim committed a breach of their lease obligations, the monthly rent would skyrocket to $96,364.80. In other words, in the event of breach, any breach, the rent would more than triple.

Harbor Island argues that, "[b]efore the Court's reversal of its legal findings, Harbor Island was required to prove only that E & J had breached its lease in *any* manner in order to recover the deferred rent." Harbor Island gives a number of examples of the type of breach it could have used to show entitlement to the $240,912 it claimed in deferred rent. One of those examples is, "Failing to obtain and provide Harbor Island with copies of maintenance contracts to maintain certain critical aspects of the property." We are at an absolute loss to imagine how $48,182.40 per month, ultimately totaling $240,912 for the period in question, could have represented "the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained" for the failure to provide copies of maintenance contracts.

Moreover, Harbor Island was not without remedy in the event of a breach of the covenant to maintain and repair the premises. ****410** The lease enumerated certain remedies available on breach and provided as well that Harbor Island was entitled to pursue any other remedies permitted by law. Harbor Island undertook that pursuit and the jury determined Harbor Island was entitled to $13,970 in compensation for maintenance and repair damages. Thus, the ***797** lease provisions concerning default remedies served to fully compensate Harbor Island with respect to the breach of the covenant of maintenance and repair, without resort to the collection of an additional $240,912 in damages, as a penalty.

"'A penalty provision operates to compel performance of an act [citation] and usually becomes effective only in the event of default [citation] upon which a forfeiture is compelled without regard to the damages sustained by the party aggrieved by the breach. The characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract.'" (*Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th at p. 977, 73 Cal.Rptr.2d 378, 953 P.2d 484.) Here, the lack of a proportional relationship between the $240,912 amount sought and the actual damages Harbor Island suffered on account of the breach of the covenant to maintain and repair could not be more obvious.

Harbor Island contends this analysis misses the boat entirely. As it states in its opening brief, the $240,912 "amount is not at all based on any approximation of damages or in place of an approximation of damages, as would be a liquidated damages clause. It is, instead, the recovery of the full amount of the agreed-upon rent, or the *actual damages.*" (Italics in original.) * * *

Underlying this argument is the unspoken point that, had every lease obligation been performed to the "T," Harbor Island would have received full and fair compensation for the use of the premises for only $48,182.40 per month. In other words, it was perfectly willing to rent the property at that price, but upon the slightest imperfection in the performance of E & J and Kim, it wanted nearly a quarter of a million dollars more for the same period of time.

Harbor Island stresses the fact that it was none too anxious to extend the lease term, since E & J and Kim had been in breach in the past. Indeed, the lease amendment stated: "Inasmuch as Lessee has previously defaulted in its ***798** obligations under the Lease, Lessee acknowledges that Lessor is incurring a substantial risk in foregoing the further marketing of the Premises for lease to a new tenant, in favor of continuing the occupancy of Lessee as described in this Amendment."

In consideration of this risk, the lease amendment contained a security feature that all parties omit to mention. It provided for the $48,182.40 per month rental for the three-month lease extension to be prorated over five months, beginning April 1, 1999 and ending August 1, 1999. In other words, E & J and Kim actually were required to begin paying $28,909.44 per month for the lease extension three ****411** months before it began and ending nearly two months before the extended term expired. Assuming the lease payments were indeed made in this manner, this, in effect, provided substantial security to Harbor Island for the lease extension. But Harbor Island wanted more. * * *

Harbor Island insists the actual loss was the amount of the rent that was conditionally deferred in anticipation of perfect performance. It was entitled to collect $96,364.80 per month in the event of imperfect performance, and E & J and Kim had breached the lease, so the entitlement was triggered. E & J and Kim having paid only $48,182.40 per month to date, there was a shortfall of $240,912 in the amount that had been paid. While Harbor Island would have waived, or forgiven, the $240,912 in the event there had been no breach of any nature, it would not waive the amount because there had been a breach, causing $13,970 in damages.

This type of circular reasoning was expressly rejected in *Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th 970, 73 Cal.Rptr.2d 378, 953 P.2d 484. There, the court exposed the double talk of a "conditional waiver" of certain prepayment charges in a loan agreement. "A forfeiture or unreasonable penalty, imposed only upon the other party's default, is unenforceable even though the same money, ***799** property or other consideration might have validly been bargained for as a form of contractual performance. A contrary conclusion would allow unreasonable late charges and other penalties to escape legal scrutiny through simple rephrasing as a conditional waiver. Under [the lender's] 'conditional waiver' theory, virtually any penalty or forfeiture could be enforced if characterized as a waiver. To accept that theory would be to 'condone a result which, although directly prohibited by the Legislature, may nevertheless be indirectly accomplished through the imagination of inventive minds.' We will not do so." (*Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th at p. 982, 73 Cal.Rptr.2d 378, 953 P.2d 484.)

D. Commercial Leasing and Public Policy Considerations

The fact that this was a commercial lease negotiated by seasoned business entities, not a consumer lease between unsophisticated individuals, has no bearing on the result. The court in *Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th 970, 73 Cal.Rptr.2d 378, 953 P.2d 484, addressed the suggestion that "a different set of rules [should] apply because [it] was an 'arm's-length commercial transaction.' [Citation.]" (*Id.* at p. 981, fn. 5, 73 Cal.Rptr.2d 378, 953 P.2d 484.) It dispelled that notion, stating, "That [the obligors] are ... business owners rather than consumers, however, does not deprive them of ****412** section 1671's protection against unreasonable penalties...." (*Ibid.*)

Finally, Harbor Island asserts that the court cannot quell its efforts to collect the additional $240,912, because rental inducements of this sort are widely used in the commercial leasing industry and public policy favors freedom of contract in commercial leases. * * * However, it is no less the policy of this state that any provision for the forfeiture of money or property without regard to the actual damage suffered constitutes an unenforceable penalty. (*Ridgley v. Topa Thrift & Loan Assn., supra,* 17 Cal.4th at pp. 977-978, 73 Cal.Rptr.2d 378, 953 P.2d 484.)

***800** III
DISPOSITION

The judgment is affirmed. E & J and Kim shall recover their costs on appeal.

WE CONCUR: RYLAARSDAM, Acting P.J., and O'LEARY, J.

Plante v. Jacobs, 10 Wis.2d 567, 103 N.W.2d 296 (1960).

Supreme Court of Wisconsin.

Eugene C. PLANTE, Plaintiff-Respondent,
v.
Frank M. JACOBS and Carol H. Jacobs, his wife, Defendants-Appellants.

June 7, 1960.

****297 *568** Suit [by plaintiff building contractor] to establish a lien to recover the unpaid balance of the contract price plus extras of building a house for the defendants, Frank M. and Carol H. Jacobs, who in their answer allege no substantial performance and breach of the contract by the plaintiff and counterclaim for damages due to faulty workmanship and incomplete construction. After a trial to the court, judgment was entered for the plaintiff in the amount ***569** of $4,152.90 plus interest and costs, from which the defendants, Jacobs, appealed and the plaintiff petitioned for a review.

The Jacobs, on or about January 6, 1956, entered into a written contract with the plaintiff to furnish the materials and construct a house, in accordance with plans and specifications, for the sum of $26,765. During the course of construction the plaintiff was paid $20,000. Disputes arose between the parties, the defendants refused to continue payment, and the plaintiff did not complete the house. On January 12, 1957, the plaintiff duly filed his lien.

The trial court found the contract was substantially performed and was modified in respect to lengthening the house two feet and the reasonable value of this extra was $960. The court disallowed extras amounting to $1,748.92 claimed by the plaintiff because they were not agreed upon in writing in accordance with the terms of the agreement. In respect to defective workmanship the court allowed the cost of repairing the following items: $1,550 for the patio wall; $100 for the patio floor; $300 for cracks in the ceiling of the living room and kitchen; and $20.15 credit balance for hardware. The court also found the defendants were not damaged by the misplacement of a wall between the kitchen and the living room, and the other items of defective workmanship and incompleteness were not proven. The amount of these credits allowed the defendants was deducted from the gross amount found owing the plaintiff, and the judgment was entered for the difference and made a lien on the premises.

***570 Opinion**

HALLOWS, Justice.

The defendants argue the plaintiff cannot recover any amount because he has failed to substantially perform the contract. The plaintiff conceded he failed to furnish the kitchen cabinets, gutters and downspouts, sidewalk, closet clothes poles, and entrance seat amounting to $1,601.95. This amount was allowed to the defendants. The defendants claim some 20 other items of incomplete or faulty performance by the plaintiff and no substantial performance because the cost of completing the house in strict compliance with the plans and specifications would amount to 25 or 30 per cent of the contract price. The defendants especially stress the misplacing of the wall between the living room and the kitchen, which narrowed the living room in excess of one foot. The cost of tearing down this wall and rebuilding it would be approximately ****298** $4,000. The record is not clear why and when this wall was misplaced, but the wall is completely built and the house decorated and the defendants are living therein. Real estate experts testified that the smaller width of the living room would not affect the market price of the house.

The defendants rely on Manitowoc Steam Boiler Works v. Manitowoc Glue Co., 1903, 120 Wis. 1, 97 N.W. 515, for the proposition there can be no recovery on the contract as distinguished from *quantum meruit* unless there is substantial performance. This is undoubtedly the correct rule at common law. For recovery on *quantum meruit*, see Valentine v. Patrick Warren Construction Co., 1953, 263 Wis. 143, 56 N.W.2d 860. The question here is whether there has been substantial performance. The test of what amounts to substantial performance seems to be whether the performance meets the essential purpose of the contract. In the Manitowoc case the contract called for a boiler having ***571** a capacity of 150 per cent of the existing boiler. The court held there was no substantial performance because the boiler furnished had a capacity of only 82 per cent of the old boiler and only approximately one-half of the boiler capacity contemplated by the contract. In Houlahan v. Clark, 1901, 110 Wis. 43, 85 N.W. 676, the contract provided the plaintiff was to drive pilings in the lake and place a boat house thereon parallel and in line with a neighbor's dock. This was not done and the contractor so positioned the boat house that it was practically useless to the owner. Manthey v. Stock, 1907, 133 Wis. 107, 113 N.W. 443, involved a contract to paint a house and to do a good job, including the removal of the old paint where necessary. The plaintiff did not remove the old paint, and blistering and roughness of the new paint resulted. The court held that the plaintiff failed to show substantial performance. The defendants also cite Manning v. School District No. 6, 1905, 124 Wis. 84, 102 N.W. 356. However, this case involved a contract to install a heating and ventilating plant in the school building which would meet certain tests which the heating apparatus failed to do. The heating plant was practically a total failure to accomplish the purposes of the contract. See also Nees v. Weaver, 1936, 222 Wis. 492, 269 N.W. 266, 107 A.L.R. 1405 (roof on a garage).

Substantial performance as applied to construction of a house does not mean that every detail must be in strict compliance with the specifications and the plans. Something less than perfection is the test of specific performance unless all details are made the essence of the contract. This was not done here. There may be situations in which features or details of construction of special or of great personal importance, which if not performed, would prevent a finding of substantial performance of the contract. In this case the plan was a stock floor plan. No detailed construction of the house was shown on the plan. There were no blueprints. ***572** The specifications were standard printed forms with some modifications and additions written in by the parties. Many of the problems that arose during the construction had to be solved on the basis of practical experience. No mathematical rule relating to the percentage of the price, of cost of completion or of completeness can be laid down to determine substantial performance of a building contract. Although the defendants received a house with which they are dissatisfied in many respects, the trial court was not in error in finding the contract was substantially performed.

The next question is what is the amount of recovery when the plaintiff has substantially, but incompletely, performed. For substantial performance the plaintiff should recover the contract price less the damages caused the defendant by the incomplete performance. Both parties agree. Venzke v. Magdanz, 1943, 243 Wis. 155, 9 N.W.2d 604, states the correct rule for damages due to faulty construction amounting to such incomplete performance, which is the difference between the value of the ****299** house as it stands with faulty and incomplete construction and the value of the house if it had been constructed in strict accordance with the plans and specifications. This is the diminished-value rule. The cost of replacement or repair is not the measure of such damage, but is an element to take into consideration in arriving at value under some circumstances. The cost of replacement or the cost to make whole the omissions may equal or be less than the difference in value in some cases and, likewise, the cost to rectify a defect may greatly exceed the added value to the structure as corrected. The defendants argue that under the Venzke rule their damages are $10,000. The plaintiff on review argues the defendants' damages are only $650. Both parties agree the trial court applied the wrong rule to the facts.

The trial court applied the cost-of-repair or replacement rule as to several items, relying on ***573** Stern v. Schlafer, 1943, 244 Wis. 183, 11 N.W.2d 640, 12 N.W.2d 678, wherein it was stated that when there are a number of small items of defect or omission which can be remedied without the reconstruction of a substantial part of the building or a great sacrifice of work or material already wrought in the building, the reasonable cost of correcting the defect should be allowed. However, in Mohs v. Quarton, 1950, 257 Wis. 544, 44 N.W.2d 580, the court held when the separation of defects would lead to confusion, the rule of diminished value could apply to all defects.

In this case no such confusion arises in separating the defects. The trial court disallowed certain claimed defects because they were not proven. This finding was not against the great weight and clear preponderance of the evidence and will not be disturbed on appeal. Of the remaining defects claimed by the defendants, the court allowed the cost of replacement or repair except as to the misplacement of the living-room wall. Whether a defect should fall under the cost-of-replacement rule or be considered under the diminished-value rule depends upon the nature and magnitude of the defect. This court has not allowed items of such magnitude under the cost-of-repair rule as the trial court did. Viewing the construction of the house as a whole and its cost we cannot say, however, that the trial court was in error in allowing the cost of repairing the plaster cracks in the ceilings, the cost of mud jacking and repairing the patio floor, and the cost of reconstructing the non-weight-bearing and nonstructural patio wall. Such reconstruction did not involve an unreasonable economic waste.

The item of misplacing the living room wall under the facts of this case was clearly under the diminished-value rule. There is no evidence that defendants requested or demanded the replacement of the wall in the place called for by the specifications during the course of construction. To tear down the wall now and rebuild it in its proper place ***574** would involve a substantial destruction of the work, if not all of it, which was put into the wall and would cause additional damage to other parts of the house and require replastering and redecorating the walls and ceilings of at least two rooms. Such economic waste is unreasonable and unjustified. The rule of diminished value contemplates the wall is not going to be moved. Expert witnesses for both parties, testifying as to the value of the house, agreed that the misplacement of the wall had no effect on the market price. The trial court properly found that the defendants suffered no legal damage, although the defendants' particular desire for specified room size was not satisfied. For a discussion of these rules of damages for defective or unfinished construction and their application see Restatement, 1 Contracts, pp. 572-573, sec. 346(1)(a) and illustrations. * * *

****300** Judgment affirmed.