# MEMORANDUM OF LAW

DATE: January 16, 1991

TO: John Lockwood, City Manager and Ed Ryan, City Auditor and Comptroller

FROM: City Attorney

SUBJECT: Proposed Major Construction Contracts for City's Clean Water Program; Use of Liquidated Damages and Termination Provisos in the Absence of Annual Appropriations

## BACKGROUND

By a memorandum dated November 20, 1990, you requested our opinion on the concept of including certain contractual provisions with respect to rights of termination and liquidated damages in proposed major construction contracts for the City's Clean Water Program. Conceptually, these suggested contractual provisions would purport to permit the City to terminate construction contracts in the absence of annual monetary appropriations, subject to payment to the contractor of a fixed and agreed upon sum in the nature of liquidated damages, if and when the City should choose to take action to terminate.

As you point out in your request, this method of authorizing major construction contracts should assist in the financing of these expensive public works improvements by potentially spreading out the cost of improvements over a period of years. In order to more fully examine this concept, we must first review some very basic principles of municipal finance as practiced for the City in accordance with the State Constitution, State laws, our City Charter and our municipal code. As you know, the major thrust of these principles is the prohibition against incurring unauthorized indebtedness and its concurrent requirement of what we commonly refer to as "pay as you go" financing. Following that discussion, we shall address some basic principles of contract law applicable to public construction contracts in this State.

## ANALYSIS

In January and March 1990, we provided you with memoranda-of-law which, among other things, indicated our views concerning the applicability of Charter sections 80 and 99 to major construction contracts of the same nature as discussed here.

On January 9, 1990, we released a memorandum-of-law which discussed the applicability of Charter sections 80 and 99 to a major construction contract for the proposed Civic Center

Project. Without going into great detail here, the major thrust of the memorandum opinion was that in our view a financing device such as certificates of participation which is fully executed or self-executing meets the State Constitution and City Charter requirements of "pay as you go" financing. On March 2, 1990, we touched upon the use of other available City funds as advances to meet the "pay as you go" requirement.

At an earlier date we discussed a proposal by our financial consultants that major construction contracts include terms which would:

1) not provide an appropriation for the entire estimated cost of the construction, and

2) give a unilateral right to the City to terminate the contract in the event the City Council should, for whatever reason, choose not to continue to appropriate monies to continue the contract.

We indicated to you orally at that time that we were concerned that such a provision could potentially be construed by the courts in such a fashion as to allow the other contracting party to be relieved of some of its obligations to perform. This concern arises due to a common-law concept embodied in contract law and generally known as the doctrine of Mutuality of Obligation. It stems from the English common-law notion of fairness and equity that a contract not be construed to be overbroad or overreaching and should give each contracting party a measure of equality as to the respective duties and obligations, rights and remedies of the parties to the contract. See generally 1 Williston On Contracts, section 105A (Jaeger 3d ed. 1957); Simpson On Contracts, sections 103, 107 (1954).

Following this discussion, it occurred to us that one potential method of achieving this equitable standard would be to provide the other contracting party with relatively equivalent rights and remedies if the City retained the unilateral right to terminate the contract by choosing not to appropriate additional monies to proceed with construction.

In considering this possibility, we take into consideration the law and doctrine of liquidated damages as applied in California to construction contracts.

The basic concept here is that the parties to a construction contract can legitimately and validly agree to fix a certain sum to be paid upon the event of a breach or termination of the contract, subject to certain conditions. This concept is most often utilized in construction contracts where time of completion of the facility being constructed is of the essence and the parties agree in advance that the builder's failure to meet the deadline will result in an agreed upon amount of monetary damages to the owner of the facility. (Obviously, the construction contract for San Diego Stadium is an apt example of that concept.) Simpson On Contracts, section 151 (1954). There are within the doctrine certain limitations such as the courts abhorrence and refusal to enforce monetary damage provisions which are deemed to be excessive under the circumstances and are in the nature of a penalty, but a properly constructed liquidated damages provision could, it seems to us, avoid this consequence.

If one keeps in mind that the legal concept of damages is to make the aggrieved party whole, not to reward him as a result of the breach nor penalize the breaching party, it again seems to us that this concept is legally sound.

One additional point should be made. In order to provide for a valid liquidated damages provision, we believe the contract itself would have to concede that the City's failure to continue appropriations would be a technical breach of the contract, thus giving rise to the liquidated damages.

All of this may be of some interest to our bond counsel and financial consultants on the Clean Water Act program. We will share this memorandum with them at the earliest possible time to obtain their views on the subject.

JOHN W. WITT, City Attorney
By
C. M. Fitzpatrick
Assistant City Attorney

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