Cost-Based Analysis Can Be Useful In Calif. Contract Disputes

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The COVID-19 pandemic has led to numerous breach of contract disputes in connection with issues such as delayed construction projects, commercial tenant disputes and supply chain disruptions. This has prompted many contracting parties to revisit and scrutinize their existing contracting practices.

While much of the legal discussion is centered around whether interpretations of force majeure clauses trigger liquidated damages, a narrow focus on force majeure may miss the fundamental question of whether those liquidated damages provisions are enforceable to begin with.

Liquidated damages provisions in contracts specify a predetermined amount of monetary damages that an injured party can recover in the event of a breach. Contracting parties generally agree to these provisions in an attempt to reduce uncertainty and avoid costly legal disputes to recover damages. In practice, these provisions can appear in a wide variety of contexts, such as late payment charges in consumer cellular phone contracts and delayed completion charges in construction contracts.

The rules governing the enforceability of liquidated damages provisions developed from common law equitable principles that prohibited the imposition of penalties, such as the inclusion of contract clauses stipulating unreasonably large sums.[1] Whether such provisions are enforceable under the law varies by state and may require analytical justification.

For example, under California Civil Code Section 1671, liquidated damages provisions in consumer contracts are void unless: (1) the amount of liquidated damages "shall be presumed to be the amount of damage sustained by a breach," and (2) it would be "impractical or extremely difficult to fix the actual damage."[2]

Paradoxically, the inherently difficult task of estimating fair compensation for actual loss is required for enforceability. As numerous court rulings have shown, failing to make a reasonable attempt to estimate potential damages before or during the contract drafting process can result in unenforceable liquidated damages provisions.[3]

In this article, we outline a cost-based framework that contracting parties can use to fix the fair amount of compensation arising from a potential breach. If done properly, such an analysis provides an estimate of the reasonable compensation for loss that can withstand judicial scrutiny in a contract enforcement action.

Liquidated Damages in California

The seminal California Supreme Court ruling in Garrett v. Coast & Southern Federal Savings Loan Association expanded on prerequisites for enforceability of liquidated damages provisions, holding that the amount of liquidated damages must "represent a reasonable endeavor by the parties to estimate fair compensation for the loss sustained."[4]

In Hitz v. First Interstate Bank, the California Court of Appeals for the Fourth Appellate District clarified that such an estimate "cannot occur without some sort of analysis of the loss that is to be compensated."[5] In other words, the contracting parties must perform an analysis to estimate fair compensation for the loss arising from a potential breach prior to setting an amount of liquidated damages.

In California, failure by the parties to undertake a reasonable endeavor to estimate damages could render a liquidated damages provision unenforceable. For example, In re: Cellphone Termination Fees Cases, the Fourth District found that the early termination fees that Sprint Spectrum LP charged its customers on cellular phone plans, which totaled nearly $300 million, were unenforceable because Sprint set the fees from a competitive standpoint instead of basing them on actual or estimated loss.[6]

The court also noted that Sprint did not analyze its lost revenue, cost savings (e.g., Sprint's avoided capital expenditures and variable costs) and expected lost profits resulting from contract terminations.[7]

This example demonstrates the litigation risk and the potential financial consequences for failing to perform a defensible analysis to estimate the actual monetary loss that would arise from a breach prior to setting the amount of liquidated damages. Although performing such an analysis can be complex and nuanced, it is possible to take a rigorous and data-driven approach.

Cost Analysis

One concrete way to think about estimating the potential losses from a breach of contract is to evaluate the categories of costs a company incurs in connection with the breach. For instance, a large organization may dedicate substantial capital and human resources to collect on delinquent invoices or retain the assistance of third-party collection agencies. The organization undertakes these collection activities in an attempt to remedy breaches by the delinquent customers, thus the costs incurred for those activities represent losses due to the breaches.

The key question is: What costs, including both cash expenditures and opportunity costs, does the damaged party incur because of the breach? Organizations can tap into historical cost and operations data and contemporaneous financial projections to help answer this question.

Identifying Relevant Elements of Loss

The first and most crucial step in developing an estimate of fair compensation for a prospective breach is to identify all the elements of potential economic loss. Often, this exercise requires interviewing knowledgeable employees at various levels within the organization to understand how potential breaches may impact its operations.

For instance, consider a cellular phone plan provider that would like to understand its costs associated with late customer payments to justify its late payment charge. In this example, the most readily apparent costs are those related to the company's efforts to collect late payments, which can include materials and labor costs associated with mailing late payment notices, inbound and outbound phone calls with delinquent customers, employing management and support staff, and facility overhead.

However, after discussion with the chief financial officer, one may find that in addition to these expenditures, the company also incurs opportunity costs — potential gains forgone because of the breach. This is because if customers had paid on time, the organization could have invested the cash in business activities to generate a return or, in the alternative, borrowed less.

Although some cost categories may be obvious, one should carefully consider all of the relevant activities and associated costs to best estimate the potential economic impact of a breach. However, in order to withstand judicial scrutiny, the analyst must be careful not to include costs that are unrelated to the breach, as this would overstate potential damages. This balancing act highlights the importance of collecting information from multiple sources, including through interviews, in order to understand how a breach affects an organization and its operations.

After identifying relevant cost categories — setting aside opportunity cost — the next step is to quantify the direct and indirect costs attributable to a potential breach. An organization's historical records and forecasts, such as accounting records of costs and revenues, financial projections and capital expenditures (or, lacking those, industry research) can form the basis for this analysis. In the next section, we provide a broad overview of how one could use such data to estimate the losses that would result from a breach.

Direct and Indirect Costs

Relevant direct costs include all the costs that an organization can directly trace as having been incurred because of the breach. These costs can be identified through an exclusive association with the breach, or through driver tracing, which uses cause-and-effect reasoning to identify activities, called cost drivers, that increase costs related to the breach.

Additionally, an organization may incur indirect costs in connection with a breach. Indirect costs cannot be directly traced as having been incurred because of the breach. These typically represent shared expenses that support multiple business activities, such as rent, office expenses, utilities and management salaries. Because indirect costs are associated with supporting multiple aspects of the business, the costs must be allocated from the larger pool of costs to identify the expenses relevant to a breach.

Returning to the cellular phone plan provider example, the direct costs attributed to late payments can include postage and handling for mailing late payment notices to delinquent customers, along with any costs for initiating outbound automatic dialer calls and maintaining an inbound call center for collections. These cost categories are clearly attributable to the breach because, absent any late payments, they would not be incurred.

By contrast, costs that support multiple areas of the business, including salaries for management personnel and support staff, and for facility and technology overhead, are indirect costs. One can allocate indirect costs to the breach by estimating the portion of the costs related to managing late payments.[8]

Assigning Costs

One way of assigning costs through driver tracing or pooled cost allocation is to identify the relevant cost driver. For example, total hours worked is a cost driver for employee pay, since a company pays employees in exchange for labor time. Direct costs assigned by driver tracing are generally incurred in direct proportion to the cost driver.

With the cost driver identified, the next step is to quantify the relationship between the cost driver and business activities attributable to the breach. Continuing with our previous example, suppose a survey of hourly employees reveals that each spends approximately eight hours per week on tasks related to processing late payments to the exclusion of all other activities.

Using time as the cost driver would suggest that 20% of these employees' time (i.e., eight hours of a 40-hour work week) is attributable to the breach. If the total annual pay for these employees were $500,000, approximately $100,000 (20%) would thus be assigned to late payment activities.

This example also highlights the advantages of using granular data to trace costs. If the company's time entry system tracked the number of hours spent dealing with late payment activities, the resulting cost assignment would likely be more accurate than if the employees had to recall from memory. In the absence of such data, the analyst could gather and validate information from multiple sources to develop the most accurate understanding of the time spent working on specific activities.

With indirect costs, the causal relationship between pooled expenses and the cost drivers are not as clear. Indeed, sometimes multiple cost drivers can be used to allocate indirect costs to business activities. The challenge then becomes selecting the cost driver that most accurately captures the economic relationship between the cost driver and the activity of interest.

For instance, the square footage of a building is one possible cost driver for allocating facility overhead costs, such as rent and utilities, to late payment activities. Suppose the employees who work on tasks related to processing late payments occupy half of a floor of an office building. A cost allocation based on square footage would allocate half of the facilities overhead costs for that floor to late payment activities. While this may seem like a reasonable approach, it will not yield accurate results if the employees working on late payment processing also work on tasks unrelated to late payments.

Because companies pay for facilities overhead and office space to enable employee productivity, the total hours worked by employees on the floor may be a more appropriate cost driver to allocate overhead costs in this example. If all the employees on the floor collectively spend approximately 10% of their time processing late payments, an allocation method based on total working hours would allocate 10% of the facilities overhead costs for that floor to late payment activities. While this amount is significantly less than the allocation based on square footage, it better captures the costs for processing late payments.

Opportunity Costs

Opportunity costs can be difficult to assess because, unlike cash expenditures, they do not appear directly in accounting records. Instead, they can be identified by analyzing the business opportunities that a company loses because of a breach.

In late payment contexts, delays in remittance prevent the intended recipient from using the withheld funds in business activities to generate a return. One method to quantify the dollar value of this lost opportunity is to estimate the forgone interest that the late payment amount would accrue over the time delayed.[9]

In practice, the company's weighted average cost of capital, which reflects its cost of debt and equity financing, is a potential measure of the interest rate.[10] As many companies regularly evaluate their weighted average cost of capital in the ordinary course of business, one can estimate the opportunity costs associated with unpaid balances (i.e., the interest-carrying costs) by evaluating historical data on late payment balances and duration.

Lost profits are another relevant opportunity cost in the context of liquidated damages. If a breach causes the damaged party to forgo future profits, such as the early termination of cellular phone contracts, the value of the forgone profits represents an opportunity cost to the provider.

In the case of early termination fees, there is clearly lost revenue associated with payments the company would have received from the customers who terminated early; however, the company would have also avoided costs associated with servicing those customers. Therefore, to avoid overstating lost profits, it is essential to deduct from the lost revenue any costs that the company would avoid because of a breach.

Allocating Total Losses

With regard to liquidated damages provisions in consumer subscription contracts, each failure by a customer to make a timely payment constitutes a breach, which means that each contract can give rise to multiple breaches. While it may be possible to estimate the total costs associated with a particular type of breach using the methods described above, it may not be possible to directly estimate the costs associated with any given breach.

In such cases, a reasonable approach for estimating the fair compensation for each prospective breach is to simply convert the total companywide costs attributable to the breaches into a cost per breach. While this seems like a straightforward exercise, failing to properly define what constitutes a breach can result in a cost per breach estimate that is unreasonably high.

Conclusion

Under California law, contracting parties must make a reasonable endeavor to estimate fair compensation for the actual loss in the event of a breach prior to specifying liquidated damages in consumer contracts. Failure to do so puts them at risk of a legal ruling that renders their liquidated damages provisions unenforceable, and which can carry serious financial consequences. By taking a rigorous, data-driven approach prior to setting liquidated damages provisions, contracting parties can better protect themselves from these risks.

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Endnotes

1 Charles T. McCormick, Handbook on the Law of Damages § 147, at 600-601 (1935), and J. Calamari and J. Perillo, The Law of Contracts, note 3, § 232, at 367-68, n.52.

2 See Cal. Civ. Code § 1671. We note that many other states share similar requirements regarding the enforcement of liquidated damages.

3 See e.g., Vitatech Internat., Inc. v. Sporn , 16 Cal. App. 5th 796 (finding that "the stipulated judgment ... is an unenforceable penalty because it bears no reasonable relationship to the range of damages the parties could have anticipated would result from Defendants' failure timely to pay the settlement amount"); Hanson v. Koller Coatings Corp. , 2011 U.S. Dist. LEXIS 165379 ("There is no evidence in the record that the liquidated damages provision at issue is a reasonable or good faith forecast of damages.... Thus, the Court concludes that the liquidated damages provision at issue isvoidas a penalty"); Idaho Plumbers & Pipefitters Health & Welfare Fund v. United Mechanical Contractors, Inc. , 875 F.2d 212 (finding that Defendant's "[liquidated damages] provision was not a good faith attempt to estimate the amount of damages flowing from the breach"); Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC , 393 P.3d 449, 452 (holding that the late fee either "duplicated" other contractual fees "or was grossly disproportionate" to the amounts "needed to compensate for the anticipated losses identified in the provision"); Easton Telecom Servs. v. CoreComm Internet Grp. , 216 F. Supp. 2d at 698 (determining on summary judgment that a liquidated damages clause for early termination fees was an unenforceable penalty under Ohio law); and Del Monte Props. & Invs., Inc. v. Dolan , 26 Cal. App. 5th Supp. 20 (2018) (finding that a liquidated damage clause in a lease may not be upheld "[i]f no effort was made to estimate the actual losses").

4 See Garrett v. Coast & Southern Fed. Sav. Loan Assn. (1973) 9 Cal.3d.

5 See Hitz v. First Interstate Bank (1995) 38 Cal.App.4th.

6 The courts often look to the intentions of the contracting parties when setting the amount of liquidated damages as evidence of whether a reasonable endeavor was made to estimate a fair compensation for loss. See e.g., Utility Consumers' Action Network, Inc. v. ATT Broadband of Southern Cal., Inc. (2006) 135 Cal.App.4th.

7 See In re: Cellphone Termination Fee Cases , 193 Cal. App. 4th 298, 329 (2011).

8 Notably, whether costs are categorized as direct costs or indirect costs largely depends on an organization's accounting practices. For instance, if a cellular phone plan provider does not track its postage and handling costs by business activity, it may need to allocate its company-wide postage and handling costs to its mailing of late payment notices.

9 These amounts are equivalent to an unsecured loan that the delinquent customers forced the company to extend to them from the due date of the unpaid balances to the date the balances were ultimately paid or written off.

10 Companies receive financing through some combination of debt and equity investment, and these investors expect a return in exchange for their investment. The WACC is a measure of the return that investors expect to earn that accounts for the company's risk and its specific mix of debt and equity. As companies generally use the WACC as the minimum expected return that it accepts for business activities, the WACC is a reasonable return to use for the purposes of calculating the opportunity cost arising from the late payment.

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