Case Alert: McGuire Explains Doctrine of “Alternative Performance” as a Way Around the Formal Requirements of Liquidated Damages Clauses

In *McGuire v. More-Gas Investments, LLC* (2013) (No. C067865, 3rd Dist. Oct. 15, 2013, 2013 Cal.App. LEXIS 819), the Court of Appeal opened up new terrain of permissible legal doctrine in situations where the parties seek to charge one party money for its failure to perform a contractual obligation: the doctrine of alternative performance. Transactional and litigation attorneys alike will find this case very useful. According to the “alternative performance” theory, which in fact has been valid law for over one hundred years, but not widely cited, a contract may provide one of the contracting parties with an “option” or “alternative” to the stipulated obligations assumed by that party in the contract, including payment of a fixed sum of money in lieu of such performance, without following the statutorily required rules of liquidated damages clauses. According to *McGuire*: “[A] provision in a contract that appears at first glance to be either a liquidated damages clause or an unenforceable penalty provision may instead merely be a provision that permissibly calls for alternative performance by the obligor.” (slip op. at 13).

Generally, real estate attorneys use a liquidated damages clause to enforce such a provision. Pursuant to California Civil Code Section 1676 (referring to Sections 1671(b) and 1677), a liquidated damages clause in a commercial real estate purchase contract is presumed valid if it meets the requirements of Civil Code Section 1677: the provision must be separately signed or initialed by each party and set out in at least 10-point bold type or in contrasting red print in at least 8-point bold type. In order to be enforceable, however, the provision must still be reasonable under the circumstances existing at the time the contract was made, pursuant to Civil Code Section 1671(b). If the amount of the charge of the liquidated damages is too high, in the absence of “grossly negligent, willful, or fraudulent breach of duty”, it may be deemed an unenforceable penalty or “forfeiture” provision, in violation of Civil Code 3275, which makes such provisions illegal and unenforceable. See *Hong v. Somerset Associates* (1984) 161 Cal. App. 3d 111 (liquidated damages provision amounting to 2% of the purchase price found reasonable and enforceable). Generally, in the absence of the liquidated damages formalities, such a provision will likely be found unenforceable, especially where there are no actual damages in the event of a breach. See, e.g., *Kuish v. Smith* (2010) 181 Cal. App. 4th 1419 (so called “non-refundable deposit” found to be an unenforceable penalty provision).

The *McGuire* court shows California attorneys a way around these formal requirements of liquidated damages. In *McGuire*, the plaintiff purchased two parcels of real property from the defendant under two separate purchase agreements. Each purchase agreement imposed additional requirements on the defendant in addition to conveying the real property to plaintiff: in the first purchase, the defendant agreed to cause certain CC&Rs that encumbered the subject property to be amended within two months of the closing date. If the defendant failed to meet this requirement, the defendant agreed to refund $80,000 of the purchase price back to the plaintiff after the closing. In the second purchase, the defendant agreed to cause a final map that would further subdivide the subject property to be recorded within 12 months after the closing, or the plaintiff had the option or requiring the defendant to re-purchase the property from plaintiff for $500,000 *more* than the original purchase price. The defendant failed to perform under both agreements and the plaintiff sued for damages. Defendant argued that both provisions were
unenforceable penalties rather than valid liquidated damages clauses. While the case does not specifically discuss it, it appears that there was no valid liquidated damages language in either contract.

Analogizing to a previously uncited California case, Stevens v. Los Angeles Dock etc. Co. (1912) 20 Cal.App. 743, and to a 40 year old Supreme Court case, Blank v. Borden (1974) 11 Cal.3d 963, the McGuire court found for the plaintiff on both contracts, stating: “[W]here the contract gives the promisor the option of alternative performance . . . no question of breach or of liquidated damages arises.” (slip op. at 19). In Stevens, the defendant had promised to complete improvements on the land it had sold to the plaintiff within 18 months of the closing date or else it would waive one-third of the purchase price. In Blank, the defendant had agreed to pay a full commission to his broker if he withdrew his property from the market before the exclusive listing period expired. In both cases, the court enforced the payment provision as “alternative performance.”

The key to determining whether these provisions are enforceable per the McGuire court is that “the contract clearly reserves to the owner [obligor] the power to make a realistic and rational choice in the future with respect to the subject of the contract. . . . In these circumstances, the contract is truly one which contemplates alternative performance, not one in which the formal alternative conceals a penalty for failure to perform the main promise.” (slip op. at 18-19, citations and quotations omitted). The McGuire court reasoned that the defendant could either obtain the amendment to the CC&Rs timely or pay the $80,000 with respect to the first contract, and could either record the final map timely or repurchase the property for $500,000 more than the original purchase price with respect to the second contract in dispute. As long as the choice is “realistic and rational” it is enforceable. If the alternative obligation is one that no reasonable party would undertake and its only purpose is to “hold over the obligor the larger liability as a threat to induce prompt payment [or performance]” then this will be deemed an unenforceable penalty provision. (slip op. at 24, citations and quotations omitted).

The alternative performance rule applies regardless of whether money is to be withheld from the obligor, as was the case in Stevens, or the obligor is required to pay the amount after the closing, as in the case of McGuire. (slip op. at 20-21). Indeed, the defendant in McGuire was obligated to pay the plaintiff all of the money back, plus $500,000 as its alternative performance. (slip op. at 23).

As with liquidated damages provisions, McGuire emphasizes that “what matters is what the parties knew or believed, and more importantly what they agreed to, at the time they entered into the . . . [subject] agreement. . . .” (slip op at 20). Compare: Ridgley v. Topa Thrift & Loan Assn. (1998) 17 Cal.4th 970, 977 (in order to be enforceable a liquidated damages provision must bear a “reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach”).

The doctrine of alternative performance will likely prove useful to both transactional and litigation attorneys unless another court further limits it or if the McGuire case is depublished in the future. Transactional attorneys can use it to craft enforceable alternative provisions that might not be workable in a liquidated damages context. Litigation attorneys now have an
alternative theory to defend poorly drafted contracts that should have, but did not include a liquidated damages provision. *McGuire* gives all attorneys and their clients more drafting options and more avenues should disputes later arise.

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