4TH CIVIL NO.
E051653

In the Court of Appeal

OF THE

State of California

FOURTH APPELLATE DISTRICT
DIVISION TWO

NON-AGRICULTURAL (OVERLYING) POOL COMMITTEE
and CALIFORNIA STEEL INDUSTRIES, INC.
Defendants and Appellants,

v.

CHINO BASIN MUNICIPAL WATER DISTRICT, et al.
Plaintiffs and Respondents.

APPEAL FROM THE SAN BERNARDINO SUPERIOR COURT
HONORABLE STANFORD E. REICHERT, JUDGE
Case No. RCVRS 51010

APPELLANT CALIFORNIA STEEL INDUSTRIES, INC.'S REPLY BRIEF

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I.
INTRODUCTION

In their opposition briefs on appeal, Watermaster and the Appropriative Pool (together, Respondents) try hard to deflect the blame for their failure to timely exercise their option to purchase 38,652 acre-feet of Pre-2007 Storage water from members of the Non-Agricultural Pool at a favorable price.[1]

First, despite the fact that the Peace II Option agreement contains every legal earmark of being an option, the Respondents argue that because they used the label "Purchase and Sale Agreement" in drafting the contract, it is not an option. That argument was rejected long ago by the California Supreme Court. Based on its substantive terms, the Peace II Option is legally an option. The agreement required CSI and other Non-Agricultural Pool members to hold open an offer to sell their Pre-2007 Storage Water for a set period of time at a set price, and neither the Appropriative Pool nor Watermaster was obligated to accept that offer.

Next, the Respondents argue that because one of the Watermaster Board members, Kevin Sage, was a member and vice-chairperson of the Non-Agricultural Pool and received the agenda and minutes for a board meeting where the board voted to approve a form of notice of intent to

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[1] In this Reply Brief, CSI uses the same defined terms as in its Opening Brief.

exercise the option, the form of notice provided actual notice to Sage as agent for CSI and the other affected Non-Agricultural Pool members. Not true, on multiple fronts. The "approved" form of notice of intent to exercise the option remained in flux on material terms. Further, Sage was not CSI's agent. And, where the required written notice was not provided, the option cannot be exercised constructively.

Finally, the Appropriative Pool asks the rhetorical question of "why Watermaster or the Appropriative Pool would have desired to pay $4.3 million more for the water by not providing notice in a manner consistent with the Agreement?" (Appropriative Pool's Respondent's Brief, p. 3.) It is not the responsibility of CSI or the Non-Agricultural Pool or the Court to speculate as to, or try to make sense of the Appropriative Pool's motives in failing to exercise what appears to have been a favorable option to the Appropriative Pool. (The Appropriative Pool would have been responsible for paying for the water, not Watermaster). Perhaps the deal did not look as good to some of the Appropriative Pool members once the auction was postponed. Perhaps there was too much risk for some of the Appropriative Pool members in exercising the option. Perhaps some of the Appropriative Pool members were unable to come up with the money to pay for their assessment for the price tag of the water. Or perhaps the Appropriative Pool was simply negligent in failing to exercise the option. The Appropriative Pool's motives are not the concern of CSI, the Non-

Agricultural Pool, or the Court. For whatever reason, the Peace II Option was not exercised.

By the same token, it is of no concern to the Court, the Appropriative Pool, or Watermaster whether CSI or other of the Non-Agricultural Pool members will benefit from Respondents' failure to exercise the option. Nevertheless, to set the record straight, CSI is not motivated by greed in bringing this lawsuit or this appeal. Its motivation has never been to try to extract a higher price for the water from the Appropriators. CSI is in the business of steel production, which requires water. To reach maximal levels of productivity while avoiding the necessity of purchasing expensive replenishment water from the Metropolitan Water District, CSI plans to use its storage water to offset future annual over-production of water. In other words, CSI is not speculating in water. It is only following its business plan of using its storage water to offset rising costs of purchasing replacement water until its storage water is depleted. (See VI AA 1407-1411.)

The Appropriators had an option to purchase Pre-2007 Storage Water from certain members of the Non-Agricultural Pool, including CSI. The option was not exercised according to its terms. Therefore, the decision of the trial court should be reversed, and the court should be ordered to issue a new order restoring CSI's Pre-2007 Storage Water to its account.

II.
APPEALABILITY OF THE APPEALED ORDER

Respondent Chino Basin Watermaster's Brief on appeal includes a comprehensive statement of appealability (see pp. 2-3), in which CSI joins with one addition. The 1978 Judgment also was the result of a trial. (III AA 473:7-10.)

III.
THE PEACE II OPTION WAS NOT UNEQUIVOCALLY EXERCISED EXACTLY AS SPECIFIED IN THE CONTRACT

A. There Is No Ambiguity—The Peace II Option Is An Option Contract

In determining whether a contract is an option contract, the court will look to its substantive terms. (*Steiner v. Thexton* (2010) 48 Cal.4th 411, 418.) The two characteristics that make a contract an option contract are (1) the seller must hold open an offer to sell property for a fixed period of time; and (2) the buyer is not obligated to accept the offer. (*Id.*) The Peace II Option is not ambiguous on either of these two points, thus fairly earning the moniker "Peace II Option." Per the option contract, the Non-Agricultural Pool members, including CSI, were required to hold open an offer to sell Pre-2007 Storage Water until December 21, 2009 (two years after court approval of the Peace II Option), and they did. (I AA 39, ¶ C.) The Appropriative Pool, through Watermaster, was entitled to accept that offer before the cutoff date but was not obligated to do so, and it did not. (*Id.*) In fact, by the express terms of the contract, if Watermaster/the

Appropriative Pool failed to exercise the option, the option would expire, and it did. (I AA 39, ¶ H.)

If there were any ambiguity on the point that the Peace II Option is an option, that ambiguity is erased by parol evidence of the parties' intention as shown by the "practical construction placed by the parties upon the instrument." (See *Universal Sales Corp. v. California Press Mfg. Co.* (1942) 20 Cal.2d 751, 761.) Here, Watermaster's "practical construction" of the Peace II Option is evident from Watermaster's many consistent references to the agreement as an "option" in various contexts where the use of the term obviously embraced its legal, substantive meaning as understood by the parties. (See V AA 1003-1005 [Watermaster brief in 2008 discussing the interpretation of the Peace II Option repeatedly uses the word "option" to describe the parties' agreement and concludes "it should be noted that there is no requirement that Watermaster purchase the water made available"]; VI AA 1370, § 3 [Watermaster counsel used the word "option" in discussing the substantive terms of the contract, to indicate Watermaster had the right but not the obligation to purchase the water]; VI AA 1372, 1373 [letters from Watermaster CEO indicating "the Appropriators have exercised their option"].)

Watermaster's use of the term "option" in these contexts is not the same as improperly using a label to characterize a contract, where the label is inconsistent with the substantive contractual terms. (*See, e.g., Steiner*, 48

Cal.4th at p. 418 [labels given to a contract are not the defining factor; rather, the terms of the contract control].) It is obvious from context that Watermaster's use of the term "option" is consistent with, and not contrary to, the substantive terms of the contract, which control. Thus, to the extent the Peace II Option is ambiguous (which it is not), this parol evidence "is entitled to great weight" and should "be adopted and enforced by the court." (*Universal Sales Corp.*, *supra*, 20 Cal.2d at p. 761.)

In trying in its brief to refute that the Peace II Option is an option agreement under the law, Watermaster gives the mis-impression that even if it did not comply with the notice provisions for the option, it nonetheless was obligated by the contract to purchase the water. (See Watermaster Brief, pp. 27.) The Peace II Option states just the opposite: "This Agreement will expire and be of no further force and effect if: Watermaster does not issue its **Notice of Intent to Purchase** in accordance with Paragraph D above within twenty-four (24) months of Court approval." (II AA 453, ¶ H, emphasis in original.) In other words, if Watermaster did not timely give notice of its exercise of the Peace II Option, it would lose its right to purchase the Pre-2007 Storage Water under that agreement.

On the other hand, the agreement specifies that the Non-Agricultural Pool would not lose rights as a result of having entered into the agreement. (*Id.*) If Watermaster did not exercise its option, the Non-Agricultural Pool members could still make their Pre-2007 Storage Water available for

purchase by Watermaster (and thus the Appropriative Pool members) under the terms of a different agreement, if they chose to do so. (*Id.* [under Amended Exhibit G to the Judgment, Non-Agricultural Pool members could choose annually to make storage water available for Watermaster to purchase on behalf of the Appropriative Pool at a fixed price]; see also IV AA 889, ¶ 9(d).)

B. Neither Watermaster Nor The Appropriative Pool Exercised The Option, Either In Writing Or As A Matter Of Pattern And Practice

Because the Peace II Option is *legally* an option agreement, a party must ***unequivocally*** exercise the option ***exactly*** as specified in the contract. (See, e.g., *Hayward Lumber & Inv. Co. v. Construction Prod. Corp.* (1953) [*Hayward*] 117 Cal.App.2d 221, 227-229.) In particular, the timing, manner and substance of exercise of the option must be exactly as called for in the option. (*Holiday Inns of America, Inc. v. Knight* (1969) 70 Cal.2d 327, 330, citing with approval, *Cummings v. Bullock* (9th Cir. 1966) 367 F.2d 182, 183.)

In their Opening Briefs, CSI and the Non-Agricultural Pool described in detail how Watermaster never exercised the Peace II Option by providing the required notice. The two items that the trial court found provided notice—the agenda and the minutes for the August 27, 2009 Watermaster board meeting—at best were preliminary in nature and neither constituted "exact compliance with the terms of the option. (See *Hayward*,

117 Cal.App.2d at p. 229.) Thus, neither constituted a "valid acceptance" of the option agreement. (See *Callisch v. Franham* (1948) 83 Cal.App.2d 427, 431.) Nor were the August agendas and minutes properly provided to CSI and the other Non-Agricultural Pool members.

Watermaster and the Appropriative Pool proffer two arguments in opposition. Their first argument is that Kevin Sage, as an alternate for Watermaster Board Member Bob Bowcock, was present at the Watermaster Board meeting, and received both the agenda and the minutes for the meeting as the agent of the Non-Agricultural Pool, including CSI. Their second argument essentially is that notice was provided because the extensive communications between Watermaster and the Appropriative Pool leading up to the deadline for exercising the Peace II Option put the Non-Agricultural Pool on notice as to Watermaster's intent to exercise the option on the deadline. Neither of these arguments has merit.

1. Sage was not and is not CSI's agent

Contrary to the arguments of both Watermaster and the Appropriative Pool, Sage was not CSI's agent for providing notice under the Peace II Option. Agency is normally created by an express contract or authorization. (See, e.g. 3 Witkin, *Summary of California Law* (10th ed.) "Agency", § 92, p. 139; see also Cal. Civ. Code §§ 2299, 2307.) Where the agency is for the purpose of entering into a contract required by law to be in writing, the authorization must also be in writing. (Cal. Civ. Code § 2309.)

Neither Watermaster nor the Appropriative Pool has provided any evidence of an express contract or authorization, either in writing or otherwise, whereby CSI made Sage its agent.

Unquestionably, the 1978 Judgment is not evidence of the creation of any agency relationship between Non-Agricultural Pool members. The judgment established the three pools of those with water rights in the Chino Basin, and also established the relationship between the pools and Watermaster. (See III AA 488-491.) Although the Judgment states that each Pool Committee shall elect a chairperson and a vice chairperson from its membership (III AA 490:23-26), the only power specifically given to a Pool chairman in the Judgment is the power to call special meetings. (III AA 491:9-11.) Even as to the Committee itself, the only power the Judgment authorizes is that "[e]ach Pool Committee shall have the power and responsibility for developing policy recommendations for administration of its particular pool." (III AA 492:7-9.) Nothing in the Judgment creates an agency relationship between a chairperson of a Pool Committee or his substitute and the Pool or any individual member of a Pool, such as CSI. Certainly nothing in the Judgment gives any Pool member—even the Pool chairperson—the right to contract for, receive notice for, or receive contract performance on behalf of any other Pool member.

Further, the signature of the chairperson on an agreement, purportedly signing for the Non-Agricultural Pool, cannot create an agency relationship between the chairperson and CSI. No one has produced any evidence that CSI ever created an agency relationship with the chairman, or if it did, the scope of the agency. All Watermaster or the Appropriative Pool point to is their allegation that Bob Bowcock signed the Peace II Option on behalf of the Non-Agricultural Pool. (See Watermaster's Brief at p. 15, citing "VI:93 AA1432".) It is only an allegation, not supported by any evidence, but the trial court improperly elevated Watermaster's allegation to a finding of fact. (VI AA 1432 [trial court found, based on Watermaster's allegation, that "Bowcock executed the purchase and sale agreement on behalf of the pool."].) In fact, there is no signed copy of the Peace II Option in evidence in this case. (Compare I AA 38-40 with IV AA 843-845.)

Further, there is no indication that Sage attended the August 27, 2090 Watermaster Board Meeting as an agent of the Non-Agricultural Pool or of CSI. Instead, the meeting minutes show Kevin Sage from Vulcan Materials Company was present at the meeting as a Watermaster Board member. The minutes do not indicate in any way that Sage was representing the Non-Agricultural Pool or any of its members other than Vulcan. (See I AA 67.)

The trial court essentially found a de facto agency relationship between Sage and CSI and the other Non-Agricultural Pool members even though Watermaster and the Appropriative Pool submitted ***no*** evidence, much less substantial evidence, to prove that purported relationship. The trial court simply concluded, admittedly based on no evidence at all:

> "In all of the many exhibits, declarations, and pages of argument submitted to the court, there is no express delegation of authority by any individual member of the non-agricultural pool to sign any agreement. Therefore the court must conclude that the delegation of authority exists by either informal agreement or custom and practice. Part of that informal agreement or custom and practice must include allowing watermaster and the appropriate [sic] pool to provide written notice to a single individual or the nonagricultural pool."

(VI AA 1433:6-14.) Even if there was evidence of an informal agreement or custom and practice, which the trial court impliedly conceded there was not, it would not be enough to create an agency relationship between Sage and CSI for the performance of the written Peace II Option agreement.

Finally, there is nothing to support Watermaster's argument that the most "reasonable recipient of the Notice is the Non-Agricultural Pool,

rather than the specific Non-Agricultural Pool members." (Watermaster's Brief at p. 15.) Pursuant to the 1978 Judgment, water is not held by the Non-Agricultural Pool at large, but rather water rights are owned by individual Non-Agricultural Pool members. (See II AA 477:28-478:2 ["Overlying rights for non-agricultural pool use . . . are individually decreed for each affected party in Exhibit 'D'."].) Further, Watermaster knows who each of the Non-Agricultural Pool members is and how to reach them, and keeps detailed accountings of each member's water rights. (See III AA 502:17-21 [Judgment requires Watermaster to maintain a current list of parties and their addresses for purposes of service].) When Watermaster began making payments under the Peace II Option, on the premise that the option had been exercised, Watermaster was able to send a letter and appropriate check to each of the affected Pool members, along with an accounting of their individual storage account balances. (See VI AA 1375-1376; see also VI AA 1410:24-1411:1.) Watermaster easily could have followed that same process to exercise the Peace II Option before the December 21 deadline. The most reasonable recipient of notice of exercise of the Peace II Option would have been each of the Non-Agricultural Pool members, including CSI, whose Pre-2007 Storage Water was affected by the option.

2. Constructive notice is not a proper substitute for written notice under the Peace II Option

Contrary to Watermaster's argument, the various communications and meeting minutes involving the Appropriative Pool and Watermaster during the period from August to December, 2009, were not a proper substitute for written notice under the Peace II Option even if such communications and minutes provided constructive notice of an intent to exercise the option (which they did not). (See, e.g., *Bekins Moving & Storage Co. v. Prudential Ins. Co.* (1985) 176 Cal.App.3d 245, 251 [*Bekins*] (neither constructive notice nor substantial compliance was a proper substitute for written notice under option agreement).) The court in *Bekins* held that extensive written and oral communications between the parties about expensive property improvements installed by the tenant shortly before the deadline for exercising the option to renew a lease did not constitute a substitute for exercise of the option. (*Bekins*, 176 Cal.App.3d at p. 251; see also *Hayward, supra*, 117 Cal.App.2d at pp. 224, 228 (neither verbal assurance of intent to exercise the option nor a tenant's curative rend payment made with the intent of preserving the option constituted actual exercise of the option).)

Even if constructive notice were allowed, however, it would not have been given on the facts here. The chronology of events below shows the fate of the Pre-2007 Storage Water was an ever-moving target.

- **August 27, 2009 Watermaster Board Meeting minutes**
The Board voted to change the form of notice as follows: "Moved to approve the Intent to Purchase to 36,000 acre-feet for use in a Storage and Recovery Agreement, and refer the 2,652 acre-feet back to the Appropriative Pool for further consideration and a separate motion, as presented." (I AA 69.) The Board also discussed a "Plan B" in the event of a failed auction, which would provide an alternative method for paying for the water if the Peace II Option was exercised. (I AA 69-70.)

- **October 1, 2009 Watermaster Staff Report**
Because of the dispute as to how the 2,652 acre-feet should be used, the Staff Report lays out "three options for disposition of this water." (I AA 74-75.) They are described as either for (1) desalter replenishment or (2) storage and recovery under section F of the Peace II Option, or (3) under section H of the Peace II Option ("if the Notice of Intent to Purchase is not issued by December 21, 2009").

- **October 1, 2009 Joint Appropriative & Non-Agricultural Pool Meeting minutes**
After a "discussion regarding safe yield, a storage and recovery program, and on the upcoming water auction," the issue of the disposition of the 2,600 acre-feet of water was "tabled for 30 days for further discussion and possible Watermaster staff recommendations." (I AA 77.) The auction was still scheduled for November. (I AA 78.)

- **November 5, 2009 Staff Report to Appropriative Pool**
"Staff recommends that the Appropriative Pool direct Watermaster to issue the Notice of Intent to Purchase prior to December 21, 2009 and place the water purchased in storage pursuant to the proposed Plan [B]." (I AA 81.) See also Watermaster Board Meeting Agenda for October 22, 2009 and Advisory Committee Meeting Agenda for meeting November 19, 2009, each attaching the November 5, 2009 Staff Report. (I AA 88-95.)

- **November 5, 2009 Joint Appropriative & Non-Agricultural Pool Meeting minutes**
Following closed session, "the Appropriative Pool reported two actions: (1) ratification of the administrative decision made by the Watermaster CEO to postpone the auction with the new date to be decided, and (2) to direct staff to implement the Alternate Plan for

Disposition of the Purchased Water as amended by the Pool with the revised version to be distributed to the Pool." (I AA 84.)

These reports, discussions and committee or board votes show a lot of issues were still up in the air between August and December, 2009, including: (1) how much water would be purchased; (2) how the water would be used; (3) whether a portion of the water could be excluded from any purchase under the Peace II Option; (4) how the cost of the water would be financed, either by auction or special assessment of Appropriative Pool members. Missing from these circumstances is any assurance that Watermaster/the Appropriative Pool unequivocally intended to exercise the Peace II Option. The Watermaster Advisory Committee, Watermaster Board, and the Appropriative Pool all considered in their meetings the Watermaster Staff Report dated November 5, 2009, which recommended "that the Appropriative Pool direct Watermaster to issue the Notice of Intent to Purchase prior to December 21, 2009." There is no indication anywhere that in any of the meetings where that recommendation was discussed, anyone responded that the Appropriative Pool ***had*** directed Watermaster to issue the required Notice or that Watermaster ***had*** issued the Notice. As of November 5, 2009, no notice of an intent to exercise the Peace II Option had been provided. By January, 2010, it was too late.[2]

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[2] The Appropriative Pool's failure to make the first payment called for under the Peace II Option until January, 2010, is further evidence that

With an option contract, "[s]ince the optioner is bound while the optionee is free to accept or not as he chooses, courts are strict in holding an optionee to exact compliance with the terms of the option." (*Bekins*, 176 Cal.App.3d at p. 250.) Here, neither Watermaster nor the Appropriative Pool exactly complied with the terms of the Peace II Option. Thus, the option was never exercised.

C. CSI Intends To Hold Its Pre-2007 Storage Water For Replenishment Resulting From Overproduction From Steel Production

Respondents ascribe avaricious motives to CSI because it brought its motion and this appeal regarding the Peace II Option. Respondents' attempts to malign CSI are unwarranted and not supported by the record, even if they are beside the point. CSI is in the business of producing steel at its Fontana site. (VI AA 1408:28-1409:2.) To support its production, CSI owns certain water rights, including an overlying right based on safe yield amounts and additional storage water. (VI AA 1409:3-6.) In most of CSI's product groups, it has the broadest production capabilities on the

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notice of exercise of the option was not given in August 2009, as Respondents claim. Watermaster makes the artificial argument that written notice was "provided" in August but was not "issued" until December 2009, and therefore the January 2010 installment was timely. (See Watermaster Brief at p. 25.) The Peace II Option, however, does not contain a separate date for "issuance" of the written notice. (II AA 453, ¶ C.) Instead, the first payment was due within 30 days from the notice. (II AA 453, ¶ D.)

West Coast. (VI AA 1409:7-8.) Currently, it employs about 1000 full-time regular employees in its Fontana Plant. (VI AA 1409:13-14.) To attain its goal of reaching high levels of productivity year after year, CSI's business plan anticipates the use of its storage water to offset rising costs of purchasing replacement water until the storage water is depleted. (VI AA 1409:15-17.) CSI has never had, and presently does not have, any expectation of receiving a windfall profit as a result of its reasonable and beneficial use of its water right entitlement. (VI AA 1409:17-19.)

Contrary to Respondents' insinuations, and as the record shows, CSI's motives are pure (but also irrelevant).

IV.
CONCLUSION

To avail themselves of an option of purchasing CSI's Pre-2007 Storage Water, Watermaster/the Appropriative Pool had to apprise CSI unequivocally of its unqualified intention to exercise its option in the precise terms permitted by the Peace II Option. It failed to do so and the Peace II Option expired.

For all of the foregoing reasons, as well as for the reasons set forth in the Appellants' Opening Briefs, the Order of the trial court should be reversed. CSI respectfully requests that the Court of Appeal issue a declaration that the Peace II Option is an option agreement, that Notice of Intent to Purchase was not given in the manner required by the Peace II

Option, and therefore the Peace II Option was never exercised and has expired.

Dated: October 28, 2011 SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

By _____
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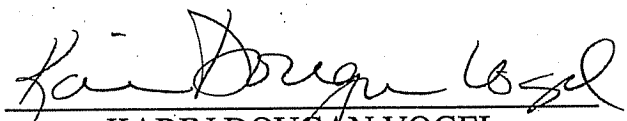
CERTIFICATE OF COMPLIANCE

I certify that, pursuant to California Rule of Court 8.204(c), the attached Appellant's Reply Brief is proportionately spaced, has a typeface of 13 points, and contains 4,141 words, according to the counter of the word processing program with which it was prepared

Dated: October 28, 2011 SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

By 

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California Court of Appeal, Fourth Appellate District, Division Two
Non-Agricultural (Overlying Pool) Committee and California Steel Industries, Inc. v. Chino Basin Municipal Water District, et al., Case No. E051653

PROOF OF SERVICE
STATE OF CALIFORNIA, COUNTY OF SAN DIEGO

I am employed in the County of San Diego; I am over the age of eighteen years and not a party to the within entitled action; my business address is 501 West Broadway, Suite 1900, San Diego, California 92101.

On **October 28, 2011,** I served the following document(s) described as **APPELLANT CALIFORNIA STEEL INDUSTRIES, INC.'S REPLY BRIEF** on the interested party(ies) in this action by placing true copies thereof enclosed in sealed envelopes and/or packages addressed as follows:

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Via electronic service

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☒ **STATE:** I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed on **October 28, 2011**, at San Diego, California.

Pamela Parker
PAMELA PARKER