#72 9/1/72

Memorandum 72-62

Subject: Study 72 - Liquidated Damages in Contracts

Background

This topic--"whether the law relating to liquidated damages in contracts and, particularly, in leases, should be revised"--was added to the Commission's agenda by the Legislature on its own initiative.

A copy of the background study prepared by our consultant, Professor Justin Sweet, is attached. Attached (yellow pages) is a summary and analysis of the background study. After you read the study, you should read this analysis.

Relevant Statutory Provisions

The basic statutory provisions dealing with liquidated damages are Sections 1670 and 1671 of the Civil Code (general provisions) and Section 2718 of the Commercial Code. For convenience, the text of these provisions is set out below.

> 1670. Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.
>
> 1671. The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.
>
> 2718. (1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.
>
> (2) Where the seller justifiably withholds delivery of goods because of the buyer's breach, the buyer is entitled to restitution of any amount by which the sum of his payments exceeds

(a) The amount to which the seller is entitled by virtue of terms liquidating the seller's damages in accordance with subdivision (1), or

(b) In the absence of such terms, 20 percent of the value of the total performance for which the buyer is obligated under the contract or five hundred dollars ($500), whichever is smaller.

(3) They buyer's right to restitution under subdivision (2) is subject to offset to the extent that the seller establishes

(a) A right to recover damages under the provisions of this chapter other than subdivision (1), and

(b) The amount or value of any benefits received by the buyer directly or indirectly by reason of the contract.

(4) Where a seller has received payment in goods their reasonable value or the proceeds of their resale shall be treated as payments for the purposes of subdivision (2); but if the seller has notice of the buyer's breach before reselling goods received in part performance, his resale is subject to the conditions laid down in this division on resale by an aggrieved seller (Section 2706).

There are a few other provisions dealing with particular areas of law.

Real Estate Leases

The measure of damages when a lease is terminated because the lessee has breached the lease and abandoned the property or when the lessee's right to possession is terminated by the lessor because of a breach of the lease adopts the "benefit of the bargain" rule. The damages recoverable by the lessee under Civil Code Section 1951.2 include:

(3) Subject to subdivision (c), the worth at the time of award of the amount by which the unpaid rent for the balance of the term after the time of the award exceeds the amount of such rental loss that the lessee proves could be reasonably avoided; and

(4) Any other amount necessary to compensate the lessor for all the detriment proximately caused by the lessee's failure to perform his obligations under the lease or which in the ordinary course of things would be likely to result therefrom.

There were objections to this measure of damages, especially where the lease has a number of years to run at the time of termination. The extent to which

Nevertheless, the Commission must decide the approach it will take to disposition of this topic from its agenda. Possible alternative methods of dealing with the topic are discussed on pages 141-145 of the study. The following are possible approaches:

1. Report to the Legislature that no revision of the existing statutes is needed. In this connection, see Clermont v. Secured Investment Corp., 25 Cal. App.3d 766 (1972). (Copy attached as Exhibit I.)

2. Revise existing statutes (Sections 1670-1671), which do not express the standards articulated in the cases, to express the entire law as articulated by the courts. (Study at 141-142.) This would eliminate the divergence between the articulated standards in the cases that determine whether or not a liquidated damage clause will be enforced and the standards set out in Sections 1670 and 1671. For discussion, see background study on page 142.

3. Revise Sections 1670 and 1671 to conform to what is actually done in the cases, rather than the articulated standards expressed in the cases. See study at 142.

4. Revise Sections 1670 and 1671 to make the standard one of reasonableness but to allow more flexibility to the parties than existing law. This solution (study at 142-145) is the one recommended by the consultant. He proposes a provision based on Commercial Code Section 2718, to read in substance:

> Where reasonable, a contractual stipulation of damages for contract breach is valid. Reasonableness may take into account:
>
> 1. The contract terms;
>
> 2. The facts and circumstances surrounding the making of the contract and its breach;
>
> 3. The anticipated harm;

4. The actual harm caused by the breach;

5. The difficulty of proof of loss; and

6. The inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

The consultant also recommends that a more precise standard might be provided in cases such as land purchase deposits, education tuition forfeitures, and late payment charges.

The provision quoted above does not indicate which party has the burden to establish that the liquidated damage clause is reasonable. (See discussion in background study at 143-144.) The staff suggests that the substance of the following provision be included in the proposed legislation:

> (a) Except as provided in subdivision (b), the party seeking to invalidate a liquidated damage provision has the burden of establishing that the provision is unreasonable.
>
> (b) If the court determines that the agreement containing the liquidated damage provision was entered into under circumstances that amounted to excessive inequality of bargaining power, the party seeking to enforce the liquidated damage provision has the burden of establishing that the provision is reasonable.

The proposed legislation should contain a provision that it does not affect the application of the Commercial Code liquidated damage provision in cases covered by the Commercial Code. In this connection, should a provision be added to the Commercial Code providing that the liquidated damage provision is not to be enforced in cases where it would be unconscionable to enforce the provision? The addition of such a provision to the California section would make it conform in substance to the Uniform Commercial Code.

The staff also suggests that a provision be included to deal with land purchase deposits. If we are to follow the consultant's recommendation, we could include a provision that a land purchase agreement may include a provision providing that the deposit made by the purchaser is to be forfeited if

he fails to go through with the agreement. Perhaps we would want to require that such a provision be in large type and be initialed by the person making the deposit (like the truth in lending statement signature requirement). The consultant points out that the validity of such a provision under existing law is doubtful.

Also, our proposed legislation probably should deal with the validity of a liquidated damage provision for late payment charge for failure to pay money on time. See the case attached as Exhibit I. The consultant has suggested this as an area where legislation would be desirable.

5. Another possible approach to the problem is suggested by Mr. Donald in his analysis of the study (attached yellow pages) on page 8.

If the Commission can determine which of the above approaches appears to be the most promising, the staff will prepare a more detailed analysis and draft statute in accord with the Commission's decision.

Respectfully submitted,

John H. DeMoully
Executive Secretary

[Civ. No. 38716. Second Dist., Div. One. Apr. 20, 1972.]

JAMES L. CLERMONT et al., Plaintiffs and Appellants, v. SECURED INVESTMENT CORPORATION et al., Defendants and Respondents.

SUMMARY

The trial court sustained without leave to amend demurrers to a complaint in a class action alleging that a loan company and its associate had exacted usurious interest from plaintiffs and members of their class or alternatively that they had wrongfully collected what constituted liquidated damage from plaintiffs and other class members under a liquidated damage provision void under Civ. Code, §§ 1670, 1671. The action was based on a clause in the loan company's promissory notes requiring the borrower to pay the late charge for each installment more than five days in arrears in an amount equal to one percent of the original amount of the promissory note. (Superior Court of Los Angeles County, No. C 973221, John L. Cole, Judge.)

The Court of Appeal reversed the trial court's order of dismissal, holding that the clause in question was a liquidated damage provision prohibited by Civ. Code, §§ 1670, 1671, except in cases where it would be impracticable or extremely difficult to fix the actual damage. The court agreed with plaintiffs' contention they had pleaded sufficient facts to justify their representing the class of borrowers to which they belonged. In view of its holding on the question of liquidated damages, the court did not reach the issue of usury. (Opinion by Clark, J., with Wood, P. J., and Lillie, J., concurring.)

HEADNOTES

Classified to McKinney's Digest

(1) **Damages § 122—Liquidated Damages and Penalties—Effect of Declaration in Instrument.**—The trial court erred in sustaining general

demurrers to a complaint alleging that a loan company and its associate had conspired to collect and had in fact wrongfully collected what constituted liquidated damages from plaintiff borrowers and other members of their class under a liquidated damage provision void under Civ. Code, §§ 1670, 1671. Plaintiffs alleged sufficient facts to justify their representing members of the class of borrowers who had paid late charges to defendants, and the clause in question requiring borrowers to pay a late charge for each installment more than five days in arrears in an amount equal to one percent of the original amount of the promissory note was a liquidated damage provision within the meaning of Civ. Code, § 1670. It was a matter of proof whether damages assessed under the provision bore some reasonable relation to probable loss and whether actual damage would have been impracticable or extremely difficult to establish in advance of default within the exception of Civ. Code, § 1671.

[See **Cal.Jur.2d**, Damages, § 206 et seq.; **Am.Jur.2d**, Damages, § 214 et seq.]

COUNSEL

Joseph I. Anderson, Kenneth Rosenberg, Terry J. Hatter, Jr., Abby Soven, Cecily Nyomarkay and Paul Chernoff for Plaintiffs and Appellants.

Leonard Smith and Stanley Stern for Defendants and Respondents.

OPINION

CLARK, J. —Plaintiffs James and Katherine Clermont, in their capacities both as individuals and as representatives of a class, appeal from an order of dismissal following the sustaining, without leave to amend, of demurrers to all eight counts of their complaint.

FACTS

Plaintiffs' action was based on the theory that defendants Les-Rob, Incorporated (Les-Rob) and Secured Investment Corporation (SIC) had conspired to exact and had in fact exacted usurious interest from plaintiffs Clermont and other members of their class (comprised of persons who

during the four years preceding the filing of the complaint had obtained loans from Les-Rob through a particular mortgage broker and had paid "late charges" to SIC for tardy payment of one or more installments on their loans) in violation of section 10242, subdivision (c), of the Business and Professions Code or, in the alternative, that defendants had conspired to collect and had in fact wrongfully collected what constituted liquidated damage from the Clermonts and other members of their class under a liquidated damage provision which was void under sections 1670[1] and 1671[2] of the Civil Code.

Plaintiffs' complaint alleged that plaintiffs and members of their class had borrowed money from Les-Rob at the maximum allowable interest rate (10% per annum) under section 10242, subdivision (c), of the Business and Professions Code; that under the terms of the note which Les-Rob had required them to make they had promised to pay "to the nominee of the holder [of the note] a late charge for each installment more than five days in arrears in an amount equal to one per cent of the original amount of this note," subject to the maximum of $45 per late charge; that in each case, before any payment was made, the borrower was notified in writing that all payments were to be made directly to SIC, Les-Rob's nominee and agent; and finally, that they and each member of their class had in fact paid one or more late charge to SIC.

CONTENTIONS

(1) Plaintiffs contend that while there are cases holding that late charge clauses like those involved here do not impose interest and thus are not usurious, and while there are other cases holding that late charge clauses are not by nature liquidated damage provisions and thus are not within the prohibition of section 1670 of the Civil Code,[1] such clauses must be either interest or liquidated damage provisions. That being so, they argue, such clauses are either illegal as usurious, or void as assessing liquidated damage. Plaintiffs also contend they have alleged facts showing they are proper representatives of their class, and that the trial judge erred in determining otherwise.

[1]Section 1670 of the Civil Code: "Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section."

[2]Section 1671 of the Civil Code: "The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage."

DISCUSSION

One line of cases validates late charge clauses in the face of the argument that they are in effect liquidated damage provisions by characterizing the charges as "additional interest." (See *Walsh* v. *Glendale Fed. Sav. & Loan Assn.* (1969) 1 Cal.App.3d 578 [81 Cal.Rptr. 804] and *O'Connor* v. *Richmond Sav. & Loan Assn.* (1968) 262 Cal.App.2d 523 [68 Cal.Rptr. 882].) On the other hand, a second body of law upholds such clauses against the challenge that they are usurious by denying that late charges are interest at all and by calling them "penalties for nonperformance." (See *First American Title Ins. & Trust Co.* v. *Cook* (1970) 12 Cal.App.3d 592 [90 Cal.Rptr. 645] and *Lagorio* v. *Yerxa* (1929) 96 Cal.App. 111 [273 P. 856].) No case that we have found discusses both the liquidated damage and usury contentions. No case discussing one contention makes reference to any case resolving the other.

The two lines of cases are in conflict unless there exists a third category, apart from liquidated damage (or "penalty for nonperformance") and interest, within which the late charge can be made to fit.

Defendants attempt to characterize the late charge as a "service fee" which defrays the cost to the lender or its servicing agent of policing a delinquent account. Defendants maintain that the borrower's failure to make timely payment of an installment sets in motion an elaborate and expensive procedure whereby the various arts of persuasion are brought to bear upon the borrower and extensive accounting operations are performed, to the benefit both of the lender and, ultimately, of the borrower himself.

We are unable, however, to discern any difference between this "service fee" and liquidated damage. As defendants describe it, the late charge or service fee is intended to compensate the lender or its agent for the extra time and effort which it must expend as a result of the borrower's tardiness. But to contend this is to say that the charge constitutes damage for breach of the borrower's obligation of timely payment. Defendants do not deny that no attempt is made to assess the delinquent borrower the precise cost of his dereliction. Rather, a contractually established fee, based strictly upon the size of the loan, is charged for every instance of tardiness, regardless of the length of delay or the amount of effort expended by the lender or its agent. We fail to see how this fixed fee can be characterized as anything but an attempt to provide for liquidated damage. (See Civ. Code, § 1670.)

Our determination that the late charge clause constitutes a liquidated damage provision is in apparent conflict with that line of cases, referred to

above, which holds that the late charge is in fact interest and not damage. But those cases either antedated passage of the usury laws (*Thompson* v. *Gorner* (1894) 104 Cal. 168 [37 P. 900] and *Finger* v. *McCaughey* (1896) 114 Cal. 64 [45 P. 1004] or involved lenders exempt from those laws (*Walsh* v. *Glendale Fed. Sav. & Loan Assn., supra,* 1 Cal.App.3d 578 and *O'Connor* v. *Richmond Sav. & Loan Assn., supra,* 262 Cal.App.2d 523) and thus did not treat the precise issue with which we are confronted. Furthermore, in each of those cases, the provision under which the late charge was imposed expressly characterized the charge as interest.

While the late charge here involved must constitute either damage or interest, it may not, without offending logic, constitute both. Having determined that the clause at issue is a liquidated damage provision, we do not reach the question of the applicability of the usury laws.

Defendants maintain that if we determine that the late charge clause is in fact a liquidated damage provision, we should make our decision prospective in operation. But our holding herein involves none of the serious consequences to the parties and to others (see *Westbrook v. Mihaly* (1970) 2 Cal.3d 765 [87 Cal.Rptr. 839, 471 P.2d 847]) which would warrant our making an exception to the rule that a decision is retrospective as well as prospective in operation.

With reference to plaintiffs' argument that they have alleged sufficient facts to justify their representing the class of borrowers to which they belong, defendants concede that the class which plaintiffs seek to represent is an ascertainable one and that it thus satisfies the first of the two criteria for a class action stated in *Daar* v. *Yellow Cab Co.* (1967) 67 Cal.2d 695 [63 Cal.Rptr. 724, 433 P.2d 732]. But defendants deny that sufficient facts are alleged to show a well defined community of interest among the members of the class, citing *Chance* v. *Superior Court* (1962) 58 Cal.2d 275 [23 Cal.Rptr. 761, 373 P.2d 849] and *Weaver* v. *Pasadena Tournament of Roses* (1948) 32 Cal.2d 833 [198 P.2d 514]. But *Chance* favors plaintiffs and *Weaver* is distinguished in *Daar.* If the question of the adhesive character of each of the standard form deeds of trust signed by members of the class involved in *La Sala* v. *American Sav. & Loan Assn.* (1971) 5 Cal.3d 864 [97 Cal.Rptr. 849, 489 P.2d 1113] did not on this basis bar a class action, and if the necessity of proof by each member of the class in *Daar* of the amount paid for taxi scrip did not preclude a class action there, we cannot see how the need for proof of payment by each member of the class can bar a class action here.

While the issue is not here considered because of the manner in which

the case has reached us, and while we do not intimate any view of its merit, we think that the question of whether the liquidated damage provision comes within section 1671 of the Civil Code will be the most crucial issue on remand. The answer will depend both upon whether damages assessed under the late charge provision bear some reasonable relation to probable loss (*Farthing* v. *San Mateo Clinic* (1956) 143 Cal.App.2d 385 [299 P.2d 977]) and whether actual damage would have been impracticable or extremely difficult to establish in advance of default (*Greenbach Bros., Inc.* v. *Burns* (1966) 245 Cal.App.2d 767 [54 Cal.Rptr. 143]).

The order appealed from is reversed. The cause is remanded for further proceedings consistent with the views expressed in this opinion.

Wood, P. J., and Lillie, J., concurred.

SUMMARY AND ANALYSIS OF BACKGROUND STUDY

By Bruce Donald

Introductory Part and Basic Policy Problems

The fundamental policy question raised by the study (p. 85) is the proper balance to be struck between party autonomy (or freedom of contract) and protection of parties prejudiced by unreasonable contractual provisions. Parties become prejudiced either because of unequal bargaining power at the time of contract (the "adhesion contract" problem) or because actual damages turn out to be significantly divergent from the amount fixed as liquidated damages.

The study emphasizes that, despite inroads by the courts, party autonomy continues to be the major factor in contract law and should remain so.

Then are listed (pp. 86-87) the reasons why liquidated damages clauses are employed in both negotiated and adhesion contracts:

1. Negotiated contracts:

(a) Improve on the deficiencies in the litigation process such as a court giving insufficient weight to what the parties may regard as legitimate factors. (It should be added that one of the major reasons in the commercial sphere is to bypass the costly and time-consuming process of litigation altogether.)

(b) Prevent problems of proof of causation and foreseeability.

(c) Provide incentive for performance (which falls short of a penalty).

(d) Minimize likelihood of breaching party disputing damages.

2. Adhesion contracts--in addition to the above:

(a) To limit liability as much as possible.

(b) To coerce performance.

The courts have responded by agreeing in general that such clauses should be enforced but have been prepared to scrutinize the clauses to protect prejudiced parties in some cases (p.88).

In considering possible reform of this area, the basic problem is how far courts are to be allowed to go in scrutinizing liquidated damages clauses to protect a prejudiced party. The indications on how attitudes are developing in California are conflicting. On the one hand, in the Commercial Code (enacted 1963), Section 2718, the general rule refusing to enforce such clauses in goods transactions was overturned in favor of a provision allowing "reasonable" liquidated damages clauses. Further, the code does not include Section 2-302 of the Uniform Commercial Code, giving the court general power to scrutinize all aspects of contracts for unconscionability.

On the other hand, the recent 1970 legislation on advance payments in leases allows courts to order repayment of such advance payments above actual lessor damages, thus effectively prevently liquidation of damages in this area.

It seems that the position taken by the study, favoring party autonomy, reasonably reflects the current thinking in this state. However, any reform should also look ahead, and it is suggested that longer term trends favor control of more and more questionable aspects of contracts. The recommendations at the end of this memorandum will attempt to preserve this balance between party autonomy and protection of prejudiced parties.

Related Contractual Clauses

The study (pp. 90-94) proceeds from general considerations to set liquidated damages clauses in the context of other related clauses:

1. Agreed valuations--it suggests that these are not appropriate for control.

2. Penalties--properly void.

3. Limitations of liability--less respectable and therefore sometimes reclassified as liquidated damages clauses when courts wish to enforce.

4. Security deposits--may or may not be classifiable as liquidated damages.

5. Alternative performances--courts have often treated a damage controlling clause as in this class when it is difficult to enforce it as liquidated damages.

The California Law (pp. 94-131)

The general rules. The study first sets out Sections 1670 and 1671 of the Civil Code (pp. 94-95), which contain the basic general law on liquidated damages and then proceeds to an in-depth study of the reactions of courts to such clauses in various types of transactions. Rather than summarizing this aspect of the study, it seems preferable to attempt a general statement of the current status of the case law on Sections 1670 and 1671 before discussing those transaction types where the study had some quarrel with the case law to see if the law is unsatisfactory in its operation.

Generally, there is a divergence between the articulated standards in the cases whereby liquidated damage clauses are enforced or not and the real standards shown by the results actually achieved by the courts.

1. Articulated standards (from the leading cases of Better Foods Mkts. Inc. v. Amercan Dist. Tel. Co., 40 Cal.2d 179, and McCarthy v. Tally, 46 Cal.2d 577).

(a) The "look forward" test: The court should place itself in the position of the parties at the time of contract and decide whether the reasonably foreseeable damages would have been impracticable or extremely difficult to fix.

(b) The "estimate" requirement: The parties must go through the process of making a reasonable endeavor to estimate what damages will be.

If both tests are satisfied, the court will enforce the clause.

2. Actual standards: Courts actually enforce clauses when:

(a) At the time of trial, the court feels that it is too difficult to apply strict damages rules to measure actual damages and that the prediction of the parties is as good as the court's.

(b) Regardless of a real attempt to estimate, the amount fixed is within the realm of reason given the circumstances of the case (e.g., where a percentage of the contract price is arbitrarily chosen in a manner clearly excluding a real "estimate," clauses have still been enforced--Inyokern Sanitation Dist. v. Haddock-Engineers, Ltd., 36 Cal.2d 450; Silva & Hill Constr. Co. v. Employers Mut. Liab. Ins. Co., 19 Cal. App.3d 916--or where a small sum is chosen consonant with the risk being assumed but quite unrelated to a real "estimate"--Better Foods, supra).

However, despite this divergence in standards, after an exhaustive survey of case types, the study is prepared to reach a general conclusion that the existing law (as interpreted and applied by the courts) is working and that there is no "outcry for reform."

3. Specific examples of actual standards. In the following specific cases, the study queried the present case law. It is proposed to evaluate these queries to get a clearer picture of the extent of whatever deficiencies there are in the law:

(a) Land sale deposits or down payments. The settled state of the law (in Freedman v. The Rector, 37 Cal.2d 16, and Caplan v. Schroeder, 56 Cal.2d 515) is that a deposit paid under a land sale contract can be retained by the vendor as liquidated damages in the event of the purchaser's breach, provided only that the sum is reasonable and both the "look forward test" and the "estimate" requirement (noted above) are satisfied.

The study quarrels with this on the ground that it does not provide a simple rule whereby deposits can be retained. It is suggested that it can be equally strongly argued that the case law has developed to an acceptable position and that there is no reason why the law should unduly favor the vendor. It is interesting that the general approach taken in the Freedman case--namely that, where damages have not been properly liquidated, the vendor has no right to be unjustly enriched--has received legislative approval in the "advance payments in leases" legislation which forces the lessor to account for deposits beyond actual damages. This is a complex policy question involving attitudes to deposits. The point sought to be made here is that the criticism made by the study may not be valid and, to that extent, the present law on liquidated damage clauses may not be deficient in this area.

(b) Sales commissions. The study indicates that the law here is unclear as to whether or not liquidated damages can be recovered. However, it points out that the "alternative performance" device has been used successfully to bypass the problem so that the deficiency in the liquidated damages rules is not of great practical significance.

(c) Education services contracts. The problem of forfeiture of school fees for uncompleted tuition is one that the study suggests is not properly solved by liquidated damage clauses and that should be specially dealt with in its own context. Hence the deficiency should not be used as an argument against existing liquidated damages rules.

(d) Contracts to lend money. Some comments in Los Angeles City School Dist. v. Landier Investment Co., 177 Cal. App.2d 744, may cause some uncertainty with the previously settled law whereby late payment charges in loan contracts have been enforced. See also Clermont v. Secured Investment Corp., 25 Cal. App.3d 766 (1972). There is some consolation in the fact that these comments were dicta in a case involving late payment of money due under a litigation settlement agreement (in which case, they may not be followed in loan contract cases).

4. Conclusions. The practical deficiencies in the general law of liquidated damages are not really sufficient to demand reform, except perhaps to amend the statute sections so that the standards articulated in those sections square with the actual standards being followed by the courts.

Special rules. Apart from the general law under Sections 1670 and 1671, two important areas are now governed by their own statutory provisions.

1. Goods transactions. As indicated, Section 2718 of the Commercial Code provides that contractual stipulations for damages will be enforced if "reasonable" (this being determined according to stated criteria). This overturns the common law rules refusing to enforce such clauses generally.

There is, as yet, no useful case law in any jurisdiction on how this new rule will operate. It appears a fair rule and certainly not in need of revision at this stage. But should the concept of "unconscionability" be introduced into Section 2718?

2. Advance payments in leases. This previously turbulent area has been legislatively settled in the 1970 amendments to the Civil Code which generally make the lessor entitled to retain only so much of the advance payment as covers actual damages. No revision is called for here.

Suggested Reform of General Law

The study suggests (pp. 144-145) that the law be changed to reverse the present articulated antipathy towards liquidated damages clauses in favor of increased party autonomy.

Whether or not this is an appropriate reform is clearly a policy decision which depends on the basic policy question discussed at the outset of this memorandum.

The method suggested is to follow and expand upon the approach taken in Section 2718 of the Commercial Code and to list a greater number of criteria which the court can consult to determine reasonableness (see pp. 144-145 of study).

The following criticisms of this suggestion seem justified:

1. The reform is intended to secure greater party autonomy, but it is suggested that to increase the criteria in the manner suggested will confer greater power on courts to scrutinize such clauses. Given a judicial tendency to police offensive contractual terms, the proposed reform may achieve a result opposite to that intended.

2. The reform broadens the inquiry to an examination of actual damages and of events at the time of trial whereas it would seem that, if party autonomy is to be preserved, the court should look only to events at the time of contract.

3. Expanding the criteria for reviewing clauses may not produce the certainty and predictability for contracting parties that is hoped for.

4. Even if this approach is regarded as proper, because there is no urgency about this, it may be more advisable to observe what happens under Section 2718 of the Commercial Code before basing further legislation upon it.

Alternative Proposal

If reform is felt to be necessary to square real and articulated standards and give some certainty to contracting parties while protecting against inequality of bargaining power and unfair prejudice of parties, Section 1670 should be repealed and Section 1671 should be amended to read:

> 1671. A contractual stipulation of damages for breach of contract is valid unless the party seeking to invalidate the stipulation satisfies the court that:
>
> (a) The stipulation was manifestly unreasonable as between the parties in the circumstances of the case at the time of contract, or
>
> (b) The stipulation was entered into under circumstances that amounted to excessive inequality of bargaining power, or
>
> (c) Enforcement of the stipulation will unjustly enrich one party to the contract or act as a penalty against the other.