

Memorandum 73-16

Subject: Study 72 - Liquidated Damages

Background

Attached are two copies of a tentative recommendation relating to liquidated damages. Please mark your suggested editorial changes on one copy and return it to the staff at the March meeting.

The tentative recommendation reflects the general policy decisions made at previous meetings. You should read the entire draft with care. At the meeting, we plan to go through the recommended legislation section by section. We note several matters of importance below.

Section 2954.6

The staff believes that the most controversial provision of the recommended legislation is Section 2954.6, which provides the rules governing late payment charges on loans secured by real property. In this connection, you will be interested to note that Assembly Bill No. 105 has been introduced at the 1973 session to deal with this problem. The bill specifies 10 percent of the installment due as the maximum charge that may be imposed on a late installment payment due on a loan secured by a mortgage or deed of trust on real property containing a single-family, owner-occupied dwelling. No five-dollar or similar minimum payment is provided. Also, Exhibit I reports that the California Supreme Court on January 17 granted a petition for hearing in a case in which the validity of late charges imposed by a savings and loan association was challenged. This indicates that the need for legislation is becoming acute if certainty as to the validity of late payment charge provisions is to be obtained.

Attached are several letters from the Western Center on Law and Poverty opposing the substance of the provision relating to late payment charges on loans secured by real property, which is contained in the attached tentative recommendation. The letters suggest that the rate should be five percent rather than 10 percent and strongly object to applying a 10-percent rate which includes impounded accounts. The letter further suggests that 12 rather than six days' grace be allowed before a payment is considered to be late. The California Savings and Loan League recommended a late charge limitation of 10 percent of the late installment and would confine this limitation to loans on single-family, owner-occupied dwellings. The California Mortgage Bankers Association recommended a five-percent charge on delinquent installments (covering principal, interest, and impounds) on commercial or industrial loans and would recommend a four-percent charge on conventional residential loans. We received no expression of views from the mortgage brokers.

The staff believes that a fair provision would be one that would permit five percent of the delinquent installment, the amount to be computed on principal, interest, and impounds for taxes and insurance. Perhaps legislation drafted in accord with this standard would have a chance for enactment, but--even considering the doubt concerning the validity of late payment charges under recent decisions--the staff believes that the likelihood of such legislation being enacted is remote. Whether the legal services lawyers (such as CRLA and Western Center on Law and Poverty) would support such legislation would be significant in determining whether to recommend such legislation. Perhaps the scheme could be further revised to provide that a five-percent charge is valid no matter what the size of the payment but that, where the payment is more than \$500, the parties may agree on a greater amount subject to the general rule on liquidated damages (Section 3319).

Section 3320

With respect to Section 3320, we have made the cut-off point \$500 to be consistent with Section 2954.6. However, the standard in Section 3320 is different than the standard in Section 2954.6 as to the maximum amount of the late payment charge, and perhaps the \$500 limit is too high.

Next Step

What is the next step? Should a tentative recommendation be distributed for comment or should a recommendation be submitted to the Legislature? Despite the objection made in the attached letters, we probably have comments from all persons and organizations that will comment. When proposed legislation is submitted, we may be able to persuade other groups--such as the mortgage brokers--to comment. On the other hand, if we wait long enough, it is possible that legislation will be enacted dealing with late payment charges on loans secured by real property, and the recommendation could then be submitted without the need for dealing with this controversial problem.

Respectfully submitted,

John H. DeMouilly
Executive Secretary

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January 17, 1973

GORDON S. DIXON
ADMINISTRATOR

California Law Revision Commission
Stanford University
Palo Alto, California

Re: Late Charges on Loans Secured by Real Estate (Study 72)

Gentlemen:

We have reviewed your staff memoranda, proposals, and exhibits on the above subject. We note that Senator Song's inquiries made at the Commission's request were not directed to any consumer groups. Nor apparently has any information been obtained from either the F.H.A. or V.A. as to their experience with relatively nominal late payment penalties.

Initially, we wish to point out that the California Supreme Court on January 17, granted a petition for hearing in Barrett v. Coast & Federal Savings and Loan Association, a case in which the validity of late charges imposed by savings and loans was challenged. Although the mere granting of a hearing in this case has particular significants in light of the fact that two Courts of Appeal have already held that provisions for the payment of additional amounts when payments are made late are not subject to the prohibitions of Civil Code §§1670 and 1671 (see Walsh v. Glendale Fed. Sav. and Loan Association) 1 Cal. App. 3d 578; O'Connor v. Richmond Sav. & Loan Assn. (1968, 262 Cal. App. 2d 523). The Commission is already fully aware of Clermont v. Secured Investment Corp. (1972) 25 Cal. App. 3d 766 in which the Court held that at least as applied to lenders who are not exempt from the usury provisions of the California Constitution charges assessed for the late payment of amounts due under a real property loan are subject to the prohibitions of Civil Code §1670 unless they fall within the exception of Civil Code §1671. In light of foregoing developments it is questionable whether the Commission should at this point make any recommendations regarding legislation until the California Supreme Court has ruled in the Barrett case.

Assuming that the Commission nonetheless feels that a legislative recommendation is appropriate at this time, we disagree with your draft recommendation.

In the 1972 session, we opposed legislation permitting late charges not exceeding 10% of the overdue payment. We must respectfully suggest that your draft recommendation is also inappropriate.

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The maximum permissible penalty should be 5% of the delayed payment. According to the information supplied with your own memo, this was the practice of at least 16% of the savings and loan associations when they were last surveyed. Apparently, they suffered no particular economic hardship or competitive disadvantage.

The portion of the payment upon which the percentage penalty is assessed should include only principal, not interest or funds to be allocated to impound accounts. Late charges should only reimburse the lender for interest earned during the period of delay, the actual and reasonable cost of processing delayed payments, and collection notices to delinquent debtors. Assessing a percentage late charge on delayed interest is very close to charging interest on interest, clearly against public policy. Assessing late charge percentages against funds to be held in impounded accounts is also inappropriate since it has often been suggested that such accounts should earn interest for the borrower.

In the past this interest has accrued to the benefit of creditors and have not been used to pay the charges assessable against the impounded account or to reduce the remainder of the borrower's debt.

There is obviously interaction between the appropriate percentage rate of late charge and the items included in the base upon which the percentage is calculated. If one adopts the two or four percent rate utilized by federal agencies, then the total payment might possibly be used. Certainly, the ten percent rate proposed in memorandum 73-1 should not include anything but principal in the base.

We urge that 12 days rather than 6 be required before any late charges may be assessed. Since Civil Code §2954.5 requires six days notice, it is only logical to allow a few additional for a good faith borrower to respond before charges are imposed.

We, of course, approve of the principle that only one late charge may be assessed against any delinquent payment and that all payments must be applied against any currently owing payment before they are applied against delinquencies as provided for in §(c)(1) of your draft.

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We feel that legislation embodying our suggestions and confined to loans secured by owner-occupied single family residences would constitute an improvement in our law and would receive responsive consideration from the Legislature.

Finally, we wish to point out that even legislation permitting a maximum penalty of 5%, while such legislation may be in conformity with the permissible late charges under the Unruh and Rees-Levering Acts is in fact regressive legislation (with respect to consumer protection) when compared with the present measure of damages for the failure to pay money due on time. Civil Code §3302 now provides that "The detriment caused by the breach of an obligation to pay money only, is deemed to be the amount due by the terms of the obligation, with interest thereon." (See also Civil Code §3287 which provide that "Every person who is entitled to recover damages certain, or capable of being made certain by calculation, and the right to recover which is vested in him upon a particular day, is entitled also to recover interest.") What this means is that where money is owed and paid late the creditor is entitled to collect 7% interest on the amount owing divided by 365 and multiplied by the number of days that the amount is paid late.

Respectfully submitted,



ABBY SOVEN
Assistant Director of Litigation

AS/dk

cc: Brian Paddock

EXHIBIT II
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February 2, 1973

Mr. John H. DeMouilly
Executive Secretary
California Law Revision Commission
School of Law - Stanford University
Stanford, California 94305

Re: LATE CHARGES ON LOANS SECURED
BY REAL ESTATE

Dear Mr. DeMouilly:

This is in response to your letter of January 23, 1973.

Your letter indicates that there has been a partial breakdown in communications. We are concerned not that Senator Song had not contacted us directly but, rather, that it appeared that consumer representatives were not solicited for their views regarding late charges. It is possible that your request to representatives of my organization to participate in this project were misdirected or lost. Although I have been inundated with material on wage garnishment the first information that I had regarding Study 72 came from a representative of CRLA. I was not able to attend the commission meeting on January 19th because I was ill.

I believe that we made our position at this time regarding late charge legislation clear in my letter of January 17, 1973. In any event, if as you state in your letter several lending organizations apparently

¹ Please take me off the wage garnishment mailing list.

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Mr. John H. DeMouilly
February 2, 1973
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believe that legislation drafted along the lines suggested by the commission staff would be too restrictive, the lending organizations would hardly support any legislation that we submitted.

Apparently, the Commission's recent concern for legislation governing late charges was triggered by the Court's opinion in the Clermont case which certainly suggests the possibility that all or some late charges will be held invalid as a matter of law. It is my understanding - and please inform me if I am incorrect - that prior to Clermont lenders were generally opposed to any regulation whatsoever regarding late charges. Thus, the willingness to submit themselves to any regulation may be related to the fear of adverse court decisions. As I mentioned in my letter, the California Supreme Court granted a hearing in Garrett v. Coast and Federal Savings and Loan Association, which involves late charges assessed by an exempt lender (in contrast to Clermont, which involves late charges assessed by a non-exempt lender). It is possible that faced with the spectre that the Supreme Court will hold all late charges imposed by real property lenders invalid as a matter of law, lenders will become a bit more reasonable in the type of legislation which they are willing to support.

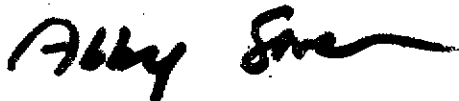
The only apparent justification for a late charge assessment (other than the loss of moneys when due, adequately compensated by interest) is to permit the lender to recover its costs in sending out collection letters and in the additional bookkeeping, if any, involved in processing a late payment. These costs would seem to be no greater whether the payment owing was \$15.00 or \$150.00. Yet, despite the fact that the Unruh Act and the Rees-Levering Act limit late charges to 5% of the monthly payment (and the Personal Property Brokers Act authorizes late charges that break down to 2% of the monthly payment) lenders - whose monthly payments are probably two to three times the amount involved in a typical consumer goods, automobile, or personal loan transaction - apparently feel that any

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amount less than 10% of the monthly payment would be a hardship. It is difficult to have any kind of meaningful dialogue given that attitude.

Again, I would like to be informed of all developments regarding the late charge study. If possible I will attend the meetings.

Sincerely yours,



ABBY SOVEN
Assistant Director of Litigation

AS:ak

cc: Brian Paddock

TENTATIVE
 RECOMMENDATION OF THE CALIFORNIA
 LAW REVISION COMMISSION
 relating to
 LIQUIDATED DAMAGES

BACKGROUND

Under existing law, the parties to a contract may, in some circumstances, agree on the amount or the manner of computation of damages recoverable for breach.¹ The general statutory provisions governing such a liquidated damages provision in California are Sections 1670 and 1671 of the Civil Code.² These sections permit the use of a liquidated damages provision only where the actual damages "would be impracticable or extremely difficult to fix." In addition, the courts have developed a second requirement that there must be a reasonable endeavor to estimate actual damages.³ The judicial decisions

1. For a discussion of the varying forms a liquidated damages clause may take, see background study: Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 90-91 (1972)(hereinafter referred to as "background study").

2. Sections 1670 and 1671, which were enacted in 1872 and have not since been amended, read:

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.

3. Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal.2d 174, 187, 253 P.2d 10, 15 (1953); McCarthy v. Tally, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956). See also Clermont v. Secured Investment Corp., 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972).

interpreting and applying Sections 1670 and 1671 provide inadequate guidance to contracting parties and severely limit the use of a liquidated damages provision.⁴ Unlike the Civil Code Sections which reflect a traditional hostility to liquidated damages provisions, recently enacted statutes such as Section 2718 of the Commercial Code⁵ encourage the use of such provisions.⁶

A liquidated damages provision may serve useful and legitimate functions.¹ A party to a contract may seek to control his risk exposure for his own breach by use of a liquidated damages provision. Such control is especially important if he is engaged in a high risk enterprise. A party also may desire to specify the damages for his own breach because he is unwilling to rely on the judicial process to determine the amount of damages. He may, for example, be fearful that the court will give insufficient consideration to legitimate excuses for nonperformance, that the court may be unduly sympathetic to the claim of the opposing party that all his losses should be paid by the breaching party, or that the court may manifest prejudice against contract breach to the extent of assessing damages on a punitive basis.

4. See background study.

5. The pertinent portion of Section 2718 provides:

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.

6. For provisions authorizing liquidated damages in marketing contracts, see Agri. Code § 54264; Corp. Code § 13353. For provisions authorizing late payment charges, see n.19 infra. For provisions authorizing liquidated damages in certain public construction contracts, see Sts. & Hwys. Code §§ 5254.5, 10503.1.

7. The following discussion draws heavily upon the background study. See background study at 86-87.

A nonbreaching party may use a liquidated damages provision because on occasion a breach will cause damage, the amount of which cannot be proved under damage rules. He may fear that, without an enforceable provision liquidating the damages, the other party will lack incentive to perform since any damages he causes will not be sufficiently provable to be collected. There is also a danger that, without a liquidated damages provision, the breaching party may recover the full contract price because the losses are not provable. A reasonable liquidated damages provision--one that is not disproportionate to actual, albeit unprovable, damages or to the contract price--is a good method of dealing with these problems.

Liquidated damages provisions may also be used to improve upon what the parties believe to be a deficiency in the litigation process--the cost and difficulty of judicially proving damages. Through a liquidation provision, the parties attempt by contract to settle the amount of damages involved and thus improve the normal rules of damages. Also, when the provision is phrased in such a way as to indicate that the breaching party will pay a specified amount if a particular breach occurs, troublesome problems involved in proving causation and foreseeability may be avoided. Finally, the parties may feel that, if they truly agree on damages in advance, it is unlikely that either would later dispute the amount of damages recoverable as a result of breach.

Use of liquidated damages provisions in appropriate cases also may improve judicial administration. Enforcement of liquidated damages provisions will encourage greater use of such provisions; will result in fewer breaches, fewer law suits, and fewer or easier trials, and in many cases will provide at least as just a result as a court trial.

While liquidated damages provisions may serve these and other useful and legitimate functions, there are dangers inherent in their use. There is the

risk that a liquidated damages provision will be used oppressively by a party able to dictate the terms of an agreement. And there is the risk that such a provision may be used unfairly against a party who does not fully appreciate the effect of the provision.

The Commission believes that the use of liquidated damages provisions is beneficial and should be encouraged and that the oppressive use of such provisions should be prevented.

RECOMMENDATIONS

Having concluded that the existing law does not permit the use of a liquidated damages provision in many cases where it would serve a useful and legitimate function, the Commission makes the following recommendations.

General Principles Governing Liquidated Damages

Sections 1670 and 1671 of the Civil Code should be replaced by a statute that applies to liquidated damages provisions in contracts generally (absent a specific statute that applies to the particular type of contract) and that implements the following basic principles:

(1) A contractual stipulation of damages should be valid unless found to be "manifestly unreasonable." This rule would reverse the basic disapproval of such provisions expressed in Sections 1670 and 1671 and in the judicial decisions while enabling courts to scrutinize such provisions in situations where they may be oppressive.

(2) Unreasonableness should be determined as of the time of the making of the contract rather than at the time of the trial. Consideration of the damages actually suffered should not be permitted. Reasonableness should be judged in light of the circumstances confronting the parties at the time of the making of the contract and not by the judgment of hindsight. Also,

consideration of actual damages would defeat one of the purposes of liquidated damages, which is to avoid litigation on the amount of actual damages.

(3) The party seeking to invalidate a liquidated damages provision should have the burden of pleading and proving that it is unreasonable. If the party seeking to rely on the provision were required to prove its reasonableness, he would lose one of the significant benefits of the use of liquidated damages, which is to simplify any litigation that may arise out of a breach of the contract.

Real Property Leases

The concurrent resolution directing the Law Revision Commission to study liquidated damages referred specifically to the use of liquidated damages provisions in real property leases. The Commission has concluded that no special rules applying to real property leases are necessary; the general rules recommended above will deal adequately with any liquidated damages problems in connection with such leases.

Land Sale Deposits

It is uncertain under existing law whether the parties to a sale of real property can agree that an "earnest money" deposit constitutes liquidated damages if the purchaser fails to complete the sale.⁸ The general rules recommended above should apply to an "earnest money" deposit; and, in addition, to avoid uncertainty, a section should be enacted to provide that an "earnest money" deposit intended as liquidated damages is valid if it does not exceed two percent of the purchase price of the property. This section should not, however, preclude the parties from agreeing on a deposit of a

8. See background study: Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 95-100 (1972).

larger amount as liquidated damages if such amount satisfies the rules for liquidated damages generally.

Late Payment Charges on Loans Secured by Real Property

The enactment of the general rule recommended by the Commission--that a liquidated damages provision is valid unless manifestly unreasonable--necessarily requires examination of the problem of late payment charges since a late payment charge provision has been held to be one liquidating damages.^{12a} The problem is especially difficult where the charge is made in connection with a loan secured by real property.

The amount of the late payment charge on a loan secured by real property is not regulated by state statute. On an FHA loan, the late payment charge is two percent of the delinquent installment. The charge on a VA loan is four percent of the delinquent installment. On other types of loans, the amount of late charges assessed a borrower varies, depending on the type of loan and the lending institution.

A 1970 report of the Assembly Finance and Insurance Committee¹³ summarizes the situation in California:

[T]here is no standard method of determining what the late charge will be based upon. Each lender is free to decide what late charge provision will be included in his promissory note form and whether the late charge shall be a percentage of the late installment, a percentage of the unpaid loan balance, a percentage of the original loan balance or a flat fee.

12a. *Clermont v. Secured Investment Corp.*, 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972).

13. Assembly Interim Committee on Finance and Insurance, Late Payment Fees (May 20, 1970)[hereinafter referred to as "Report of Assembly Committee"].

A survey of late charges for California state licensed savings and loan associations was conducted by the State Savings and Loan Commissioner in August of 1966. That survey indicated that a majority (113) of the 200 associations chartered at that time charged between 1% and 10% of the monthly payment as a late charge. Twenty-one associations in that same survey charged 1/10th of 1% of the unpaid loan balance while only 11 associations charged a flat fee, usually \$5.00.

This survey indicated that the greatest number of savings and loan associations (73) in California charged 10% of the monthly payment as a late charge. The next highest category was a charge of 4% to 5% of the monthly payment by 27 associations. The third highest category was 21 associations charging 1/10 of 1% of the unpaid loan balance.

The California Savings and Loan League conducted a separate survey of delinquent penalties assessed by all California savings and loan associations in June of 1968. This survey determined that 72 associations (31%) charged 10% of the monthly payment as a delinquent penalty. 13% charged 1/6th of 1% of the unpaid principal balance. The next highest category was 11-1/2% which charged 1/10th of 1% of the unpaid principal balance. 49% of all associations charged between 2 and 10% of the installment as a late charge.

It is interesting to note from this survey what other types of delinquent penalties are assessed the borrower. One association charges a maximum of 20 percent of the monthly payment, another charges one percent per day of the monthly payment while two associations charge one percent of the original principal balance. Two other associations charge 1/8 percent of the unpaid balance and 1/9 percent of the unpaid balance. Two additional associations would increase the rate of the note to a set percentage per annum due to the delinquent payment.

This committee has received numerous complaints from borrowers regarding the amount of penalties assessed for late payment of installments. One was a late charge of \$41.92 assessed by a savings and loan association on a monthly payment of \$196.00, which would be calculated to 21.38% of that delinquent payment. Another example of late charges was that one borrower was charged \$139.20 on a loan payment of \$560.00 for being in default for seven payments, or 24.85%.

The work sheet on one loan indicates that the borrower took out an original loan of \$1400.00 payable in monthly installments of \$20.00 each. From November 10, 1964, to July 24, 1969, the borrower paid a total amount of \$1170.00. Of that figure only \$78.18 was applied to the principal amount and \$664.82 was applied to the interest. There were 28 late payments during this period which were assessed at \$14.00 each for a total amount (including six telegrams that were sent) of \$427.00 for penalty assessments on late payments. It is interesting to note that after paying on the original amount of \$1400.00 for five years the unpaid principal balance due was \$1321.82.

The situation reported by the Assembly Committee apparently has not changed. A 1972 court of appeal decision¹⁴ involved a note which required the borrower 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 this loan," subject to a maximum of \$45 per late charge.

Efforts have been made to secure the enactment of legislation to regulate late payment charges on loans secured by real property. The 1970 report of the Assembly Committee on Finance and Insurance¹⁵ discusses three bills introduced at the 1969 session.¹⁶ At the 1972 session, Assembly Bills 1516 and 2193 were introduced to regulate late payment charges on real property loans, but neither of the bills was enacted. Assembly Bill 105, introduced at the 1973 session, also deals with the same problem.

The validity of late payment charges imposed on delinquent installments on loans secured by real property is doubtful. In Clermont v. Secured Investment Corp.,¹⁷ the court held a late payment charge was a liquidated damage provision and valid only if the "damages assessed under the late charge provision bear some reasonable relation to probable loss . . . and . . . actual damages would have been impracticable or extremely difficult to establish in advance of default."

14. Clermont v. Secured Investment Corp., 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972).

15. See n.13 supra.

16. A.B. 517, A.B. 1909, A.B. 1924.

17. 25 Cal. App.3d 766, 771, 102 Cal. Rptr. 340, ____ (1972). On January 17, 1973, the California Supreme Court granted a petition for hearing in Barrett v. Coast & Federal Savings & Loan Association, a case in which the validity of late charges imposed by savings and loan associations has been challenged.

The regulation of late payment charges on loans secured by real property is a matter involving conflicting policy considerations. The report of the Assembly Committee states:

From the lenders point of view, the imposition of a substantial late payment charge serves the purpose of reducing the institution of foreclosure proceedings when a borrower is tempted to use his funds to meet obligations other than his mortgage payment. Without such delinquency charges at relatively high levels, a borrower may let his mortgage payment slide while making other pressing debt payments. However, generally, a mortgagee or trustee will only allow no more than 60 days to elapse from the date of payment before filing notice of a delinquency and instituting foreclosure proceedings. It is important that borrowers be made to feel the impact of potential late payment charges. If foreclosure proceedings start, it will be much more expensive to cure than would the cost of any reasonable late charge.

Most lenders would agree that late fees should not be a source of extra profit to the lender. The fee should be adequate, however, to defray any additional expense involved in processing a late payment as well as compensating for lost interest which could have been earned if the payment were made on time. In addition, there should be a "motivation factor" included. This would be a sum reasonably designed to encourage prompt payment of the installment without amounting to an exorbitant or unconscionable charge.

At the time a promissory note is executed by a borrower, he will usually pay little attention to late payment provisions or various penalty provisions. His main interest on real property loan transactions is the interest rate, the term of the loan and his monthly payments. Since most debtors, at the time of borrowing, do not intend to make payments late, they are not inclined to actively negotiate over delinquency payment clauses. Nor are they likely to compute out the actual amount which would be due if a penalty of 1% of the original balance of a loan were assessed.

The Commission has considered a suggestion that restrictions on late payment charges for real property loans should be comparable to those imposed under Civil Code Sections 1803.6 (retail installment sales) and 2982 (automobile sales finance act). These provisions in substance limit the late payment charge to five percent of the delinquent installment or five dollars, whichever is less. The Commission has concluded that such strict regulation of late payment charges on loans secured by real property could operate to

the detriment of both borrowers and lenders. If the lender is forced to use foreclosure proceedings because the late payment charge is insufficient to encourage borrowers to make their mortgage payments when due, the cost to the borrower of curing the default will be much more expensive than the cost of a reasonable late payment charge.¹⁸ On the other hand, a foreclosure procedure often is not useful as a practical matter if the lender has only a second mortgage or trust deed, and such a lender would benefit from the enactment of legislation authorizing a reasonable late payment charge.

The Commission has concluded that a statutory provision should be enacted to regulate late payment charges on loans secured by real property. Such a provision would eliminate the uncertainty that now exists as to the validity of such late payment charges and would put a stop to the practice of some lenders who are now imposing what the Commission considers an unreasonably high charge. The amount permitted to be charged under such a statutory provision would be a maximum. The enactment of such a provision would not require lenders to impose a late payment charge equal to this maximum amount, and the Commission anticipates that many lenders will continue to impose a late payment charge that is less than the maximum permitted.

Where the installment payments are \$500 or more, the Commission recommends that the validity of the late payment charge should be subject to the general provision relating to liquidated damages; the late payment charge would then be valid "unless the party seeking to invalidate the provision

18. Section 2924c of the Civil Code provides that, after the recording of the notice of default, the borrower may cure the default by paying "the entire amount then due . . . (including costs and expenses actually incurred in enforcing the terms of such obligation, deed of trust or mortgage, and trustee's or attorney's fees actually incurred not exceeding one hundred dollars (\$100) in case of a mortgage and fifty dollars (\$50) in case of a deed of trust or one-half of one per cent of the entire unpaid principal sum secured, whichever is greater)"

establishes that it was manifestly unreasonable under the circumstances existing at the time of the making of the contract." This general standard gives the parties considerable freedom to negotiate a provision appropriate to the circumstances but permits a court to invalidate an unconscionable provision.

Where the installment payments are less than \$500, the Commission recommends that a late payment charge should be valid only if it satisfies the requirements of existing Civil Code Section 2954.5 (general prerequisites to imposition of late payment charge) and both of the following conditions:

(1) No late payment charge should be permitted on an installment payment which is paid in full within six days after its scheduled due date even though an earlier maturing installment payment, or a late payment charge on an earlier installment payment, may not have been paid in full. Payments should be applied first to current installments and then to delinquent installments. An installment should be considered paid as of the date it is delivered if delivered in person or the date it is postmarked if delivered by mail.

(2) The amount of the late payment charge should not exceed 10 percent of the installment payment except that, where the installment payment is less than fifty dollars, a late payment charge should be permitted not to exceed five dollars or 20 percent of the installment payment, whichever is the lesser amount. The amount of the charge should be computed on the portion of the payment which represents principal, interest, and impounds for taxes and property insurance.

Late Payment Charges Generally

Although there is no state statute regulating late payment charges on loans secured by real property, there are numerous statutes that regulate the amount that may be imposed as a late payment charge under other types

of contracts requiring installment payments.¹⁹ No change is recommended in these provisions. However, to avoid uncertainty and to protect against oppression, a section should be enacted to regulate the amount of a late payment charge that will be permitted in those contracts not now covered by statute. Specifically, where the amount of the late payment charge is not otherwise regulated by statute, a late payment charge on a contract requiring periodic payments of less than five hundred dollars each should be permitted if the amount of the charge does not exceed five percent of the delinquent installment or five dollars, whichever is less, but a minimum charge of one dollar should be permitted. This restriction is the same in substance as those imposed by existing statutes regulating late payment charges for retail installment sales²⁰ and automobile installment sales.²¹ An installment should be considered delinquent only if it is not mailed or delivered in person within six days of the date it became due.

Where the installments are at least five hundred dollars each, the amount of the late payment charge should be left to the parties to negotiate subject to the general rules governing liquidated damages.

PROPOSED LEGISLATION

The Commission's recommendations would be effectuated by enactment of the following measure:

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19. Civil Code §§ 1803.6 (retail installment sales), 2982 (automobile sales finance act); Fin. Code §§ 14852 (credit unions), 18667(a)(5) and 18934 (industrial loan companies), 22480 (personal property brokers). See also Pub. Res. Code § 6224 (failure to pay State Lands Commission); Sts. & Hwys. Code § 6442 (Improvement Act of 1911).
 20. Civil Code § 1803.6.
 21. Civil Code § 2982.

An act to amend Sections 1951.5 and 3358 of, to add Sections 2954.6, 3319, 3320, and 3321 to, and to repeal Sections 1670 and 1671 of, the Civil Code, relating to liquidation of damages.

The people of the State of California do enact as follows:

Section 1. Section 1670 of the Civil Code is repealed.

~~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.~~

Comment. Sections 1670 and 1671 are superseded by Section 3319. See also Sections 2954.6, 3320, and 3321.

Sec. 2. Section 1671 of the Civil Code is repealed.

~~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.~~

Comment. See Comment to Section 1670.

Sec. 3. Section 1951.5 of the Civil Code is amended to read:

1951.5. ~~Sections 1670 and 1671~~ Section 3319, relating to liquidated damages, apply applies to a lease of real property.

Comment. Sections 1670 and 1671 are superseded by Section 3319.

Sec. 4. Section 2954.6 is added to the Civil Code, to read:

2954.6. (a) As used in this section:

(1) "Late payment charge" means a charge, whether or not characterized in the loan contract as interest, that is imposed for late payment of an installment payment due on a loan secured by a mortgage or deed of trust on real property.

(2) "Installment payment" means that portion of a periodic payment that comprises any one or more of the following: Principal, interest, and funds to be allocated to the property tax and property insurance impound accounts.

(b) Where each of a majority of the installment payments is five hundred dollars (\$500) or more, a provision in the loan contract imposing a late payment charge is valid if it satisfies the requirements of Sections 2954.5 and 3319 and all other applicable provisions of law.

(c) Where each of a majority of the installment payments is less than five hundred dollars (\$500), a provision in the loan contract imposing a late payment charge is valid if it satisfies the requirements of Section 2954.5 and both of the following conditions:

(1) No late payment charge may be collected on an installment payment which is paid in full within six days after its scheduled due date even though an earlier maturing installment payment, or a late payment charge on an earlier installment payment, may not have been paid in full. For the purposes of this subdivision, payments are applied first to current installment payments and then to delinquent installment payments, and an installment payment shall be considered

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paid as of the date it is delivered if delivered in person or the date it is postmarked if delivered by mail.

(2) The amount of the late payment charge shall not exceed 10 percent of the installment payment except that, where the installment payment is less than fifty dollars (\$50), a charge not to exceed five dollars (\$5) or 20 percent of the installment payment, whichever is the lesser amount, may be made.

(d) Nothing in this section excuses or defers the borrower's performance of any obligation incurred in the loan transaction, other than his obligation to pay a late payment charge, nor does this section impair or defer the right of the lender to enforce any other obligation including but not limited to the right to recover costs and expenses incurred in any enforcement authorized by law.

(e) This section does not apply to loans made by a credit union subject to the provisions of Division 5 (commencing with Section 14000) of the Financial Code, by an industrial loan company subject to the provisions of Division 7 (commencing with Section 18000) of the Financial Code, or by a personal property broker subject to the provisions of Division 9 (commencing with Section 22000) of the Financial Code.

Comment. Section 2954.6 regulates the amount of a late payment charge that may be imposed for late payment of an installment payment on a loan secured by real property. The section supplements Section 2954.5 which states the prerequisites to imposition of such a late payment charge.

The primary purpose of Section 2954.6 is to provide a clear and certain rule where the installment payments are less than five hundred dollars.

Under prior law, the validity of late payment charges on loans secured by real estate was uncertain. See Clermont v. Secured Investment Corp., 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972), and cases cited therein.

Subdivision (a). The definition of "late payment charge" in subdivision (a)(1) makes clear that the provisions of Section 2954.6 cannot be avoided by characterizing the charge as interest. Compare Walsh v. Glendale Fed. Sav. & Loan Ass'n, 1 Cal. App.2d 578, 81 Cal. Rptr. 804 (1969); O'Connor v. Richmond Sav. & Loan Ass'n, 262 Cal. App.2d 523, 68 Cal. Rptr. 882 (1968). See also discussion in Clermont v. Secured Investment Corp., supra. As subdivision (d) makes clear, Section 2954.6 has no effect on such rights of the lender as the right to accelerate or the right to recover attorney's fees and other costs, expenses, and fees in event of a default. These rights are not embraced within the term "late payment charge."

The definition of "installment payment" in paragraph (2) of subdivision (a) makes clear that the amount of the late payment charge is computed using the amount obtained by totaling the amounts of the items listed in the paragraph to the extent they are included in the payment and excluding the amounts of any other items included in the payment.

Subdivision (b). Subdivision (b) makes clear that a late payment charge on an installment payment of five hundred dollars or more is subject to the requirements of Sections 2954.5 (prerequisites to imposition) and 3319 (general rule governing validity of liquidated damages provision). Accordingly, assuming that the requirements of Section 2954.5 are satisfied, the late payment charge will be valid "unless the party seeking to invalidate the provision establishes that it was manifestly unreasonable under the circumstances existing at the time of the making of the contract." See Section 3319.

Subdivision (c). Subdivision (c) is designed to avoid litigation as to the validity of a late payment charge where the installment payment is less than five hundred dollars. Where the payments are less than five hundred dollars, the need to avoid the expense to the parties of litigating the validity of the amount of the late payment charge necessitates the adoption of a statutory standard for such charges. (Subdivisions (b) and (c) are phrased in recognition of the fact that the loan may require a balloon payment or a smaller final payment.)

The amount of a late payment charge permitted under subdivision (c) is a maximum. Nothing requires that the lender impose a late payment charge equal to this maximum amount, and the practice of many lenders is to impose a late payment charge that is less than the maximum permitted by subdivision (c). See Recommendation and Study Relating to Liquidated Damages, 11 CAL. L. REVISION COMM'N REPORTS 000, 000 (1973).

Subdivision (d). Subdivision (d), which is comparable to subdivision (e) of Section 2954.5, makes clear that Section 2954.6 restricts only late payment charges. The section has no effect on the other rights of the lender, including but not limited to such rights as the right to accelerate (but see limitation in Section 2924.5) and the right to record notice of default under Section 2924 and recover costs, expenses, and fees under Section 2924c if the debtor cures the default.

Subdivision (e). The late payment charges permitted on loans excepted by subdivision (e) are prescribed by other statutes. See Fin. Code §§ 14852 (credit union), 18667(a)(5) and 18934 (industrial loan companies), 22480 (personal property brokers).

Sec. 5. Section 3319 is added to the Civil Code, to read:

3319. A provision in a contract liquidating the damages for breach of a contractual obligation is valid unless the party seeking to invalidate

the provision establishes that it was manifestly unreasonable under the circumstances existing at the time of the making of the contract.

Comment. Section 3319, providing that a liquidated damages provision is valid unless proved manifestly unreasonable, reflects a policy that strongly favors the use of such provisions. See Recommendation and Study Relating to Liquidated Damages, 11 Cal. L. Revision Comm'n Reports 000 (1973).

Section 3319 limits the circumstances that may be taken into account in the determination of reasonableness to those existing "at the time of the making of the contract." Accordingly, the amount of damages actually suffered has no bearing on the validity of the liquidated damages provision. The validity of the provision depends upon its reasonableness at the time the contract was made. To permit consideration of the damages actually suffered would defeat one of the legitimate purposes of the clause which is to avoid litigation on the damages issue. Contrast Commercial Code Section 2718 which permits consideration of the "actual harm caused by the breach."

Relevant considerations in the determination whether the amount of liquidated damages is so high or so low as to be "manifestly unreasonable" include but are not limited to such matters as the relative equality of the bargaining power of the parties, the anticipation of the parties that proof of actual damages would be costly or inconvenient, the range of damages that reasonably would have been anticipated by the parties, and whether the liquidated damages provision is included in a form contract provided by one party. Thus, for example, there is little likelihood that a specially drafted liquidated damages provision in a contract executed by informed parties represented by attorneys after proper negotiation would be held invalid under Section 3319. On the other hand, Section 3319 requires that an unconscionable liquidation of damages provision in a form contract prepared

by a party having a greatly superior bargaining position be held invalid.

To further implement the policy favoring liquidated damages provisions, Section 3319 places on the party seeking to avoid the provision the burden of pleading and proving that the liquidated damages provision is invalid. To require the party seeking to rely on the clause to plead and prove its reasonableness would destroy one of the significant benefits of the clause.

Section 3319 supersedes former Civil Code Sections 1670 and 1671. Section 1671 permitted liquidated damages only where the actual damages "would be impractical or extremely difficult to fix." This ambiguous limitation failed to provide guidance to the contracting parties and unduly limited the use of liquidated damages provisions. In addition, the courts developed a second requirement under Sections 1670 and 1671--that there be a reasonable endeavor to estimate actual damages. See Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal.2d 174, 187, 253 P.2d 10, 15 (1953); McCarthy v. Tally, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956). Section 3319 does not limit the use of liquidated damages provisions to cases where damages would be difficult to fix or where it is likely that the amount selected by the parties is an accurate estimate of actual damages as a court could make. Instead, the parties are given considerable leeway to determine damages for breach. All the circumstances existing at the time of the making of the contract are considered, including but not limited to the relationship the damages provided bear to the range of harm that reasonably could be anticipated at the time of the making of the contract.

Instead of promising to pay a fixed sum as liquidated damages in case of a breach, a party to a contract may provide a deposit as security for the performance of his contractual obligations, to be forfeited in case of a breach.

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If the parties intend that the deposit be liquidated damages for breach of a contractual obligation, the question whether the deposit may be retained in case of breach is determined just as if the amount deposited were promised instead of deposited, and the standard provided in Section 3319 controls this determination. On the other hand, the deposit may be nothing more than a fund to secure the payment of actual damages if any are recovered; and, in such case, the deposit is not considered as liquidated damages. See Section 1951 (payment or deposit to secure performance of rental agreement). Compare Section 1951.5 (liquidation of damages authorized in real property lease).

Section 3319 does not, of course, affect the statutes that govern liquidation of damages for breach of certain types of contracts. E.g., Com. Code § 2718. See also Civil Code Section 3320 which prescribes the amount of a late payment charge that may be imposed under the contracts to which that section applies. For other late payment charge provisions, see, e.g. Civil Code Sections 1803.6 (retail installment sales), 2954.6 (real estate loans), 2982 (automobile sales finance act), 3320 (late payment charges generally); Financial Code Sections 14852 (credit union), 18667(a)(5) and 18934 (industrial loan companies), 22480 (personal property brokers). These other statutes--not Section 3319--govern the situations to which they apply. Compare Section 3321, which establishes an amount of earnest money deposit that is deemed to satisfy Section 3319 but does not preclude the parties from providing for a different amount of deposit if such amount satisfies the requirements of Section 3319.

Sec. 6. Section 3320 is added to the Civil Code, to read:

3320. (a) Except as otherwise provided by law, where a contract requires periodic payments of money by one party to the other and each of a majority of the periodic payments is less than five hundred dollars (\$500), a provision in the contract imposing a late payment charge shall be deemed to be reasonable and to satisfy the requirements of Section 3319 only if both of the following conditions are satisfied:

(1) No late payment charge may be collected on an installment which is paid in full within six days after its scheduled due date even though an earlier maturing installment, or a late payment charge on an earlier installment, may not have been paid in full. For the purposes of this subdivision, payments are applied first to current installments and then to delinquent installments, and an installment shall be considered paid as of the date it is delivered if delivered in person or the date it is postmarked if delivered by mail.

(2) The amount of the late payment charge does not exceed five percent of the delinquent installment or five dollars (\$5), whichever is less, but a minimum charge of one dollar (\$1) may be made.

(b) Nothing in this section precludes the parties to a contract, where each of a majority of the periodic payments is five hundred dollars (\$500) or more, from providing a specified late payment charge as liquidated damages if such provision satisfies all applicable provisions of law.

(c) Nothing in this section excuses or defers the performance of any obligation under the contract, other than the obligation to pay a late payment charge, nor does this section impair or defer the right of the party to whom the periodic payment is payable to enforce any other

obligation under the contract including but not limited to the right to recover costs and expenses incurred in any enforcement authorized by law.

(d) This section does not apply to any contract to which the Commercial Code applies.

Comment. Section 3320 is designed to avoid litigation as to the validity of a late payment charge in cases where a contract requires periodic payments of less than five hundred dollars. Where the payments are less than five hundred dollars, the need to avoid the expense to the parties of litigating the validity of the amount of the late payment charge necessitates the adoption of a statutory standard for such charges. Under prior law, a late payment charge was held to be an attempt to liquidate damages, but the validity of such a charge as liquidated damages was uncertain. Clermont v. Secured Investment Corp., 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972).

Section 3320 does not apply where the amount of a late payment charge is prescribed by another statute. E.g., Civil Code §§ 1803.6 (retail installment sales), 2954.6 (real estate loans), 2982 (automobile conditional sales); Fin. Code §§ 14852 (credit unions), 18667(a)(5) and 18934 (industrial loan companies), 22480 (personal property brokers). See also Pub. Res. Code § 6224 (failure to pay to State Lands Commission); Sts. & Hwys. Code § 6442 (Improvement Act of 1911).

Section 3320 does not relieve the parties from complying with any applicable law which prescribes requirements governing such matters as notice of delinquency or manner of execution of the agreement. See, e.g., Civil Code § 2954.5.

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Subdivision (b) makes clear that, where the contract requires periodic payments of five hundred dollars or more, a late payment charge is valid only if it satisfies the requirements of Section 3319 and any other applicable requirements.

Subdivision (c) is comparable to subdivision (d) of Section 2954.6. See the Comment to that section.

Subdivision (d) makes clear that Section 3320 does not apply to any contract to which the Commercial Code applies; the amount of a late payment charge which may be imposed pursuant to a contract to which the Commercial Code applies is to be determined pursuant to that code. See Com. Code § 2718.

Sec. 7. Section 3321 is added to the Civil Code, to read:

3321. (a) Subject to Section 3319, the parties to a contract for the sale of real property may provide by a clause separately signed or initialed by each party that any part or all of any deposit that actually is made by the purchaser shall constitute liquidated damages to the vendor if the purchaser fails to proceed with the purchase. For the purposes of this section, "deposit" includes but is not limited to a check, (including a postdated check), note, or other evidence of indebtedness.

(b) For the purposes of subdivision (a), the amount specified by the parties as liquidated damages shall be deemed to be reasonable and to satisfy the requirements of Section 3319 if it does not exceed two percent of the total purchase price in the contract. Nothing in this subdivision precludes the parties from agreeing on a greater amount as liquidated damages if such agreement satisfies the requirements of subdivision (a).

Comment. Section 3321 makes clear that the parties to a contract to purchase land may agree that all or a part of the deposit ("earnest money") that actually is made by the buyer constitutes liquidated damages if the buyer defaults. Such a provision is valid unless the amount of the deposit is "manifestly unreasonable." See Section 3319. Under prior law, the validity of the use of a deposit as liquidated damages was uncertain. See Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 95-100 (1972), reprinted in 11 Cal. L. Revision Comm'n Reports 000-000 (1973). Subdivision (b) is included to avoid disputes as to the reasonableness of the amount specified to be liquidated damages that does not exceed the two-percent limitation. The subdivision does not preclude the parties from providing that a larger amount constitutes liquidated damages if the requirements of subdivision (a) and Section 3319 are satisfied. Section 3321 does not deal with the validity of a provision giving the buyer a right to recover liquidated damages; the validity of such a provision is determined under Section 3319.

Sec. 8. Section 3358 of the Civil Code is amended to read:

3358. ~~Notwithstanding~~ Except as otherwise provided by law, ~~notwithstanding~~ the provisions of this chapter, no person can recover a greater amount in damages for the breach of an obligation than he could have gained by the full performance thereof on both sides, except in the cases specified in the Articles on Exemplary Damages and Penal Damages, and in Sections 3319, 3320, 3321, 3339, and 3340.

Comment. Section 3358 has been amended to recognize that the parties to a contract may agree on a clause liquidating the damages for breach of an obligation. See the Comment to Section 3319.

Sec. 9. This act applies to contracts executed before as well as those executed after its effective date, but nothing in this act invalidates any provision in a contract executed prior to the effective date of this act if such provision is valid on the day prior to the day this act takes effect.