#72

10/3/73

Memorandum 73-78

Subject: Study 72 - Liquidated Damages (Comments on Tentative Recommendation)

The Commission has received over 25 letters commenting on the tentative recommendation relating to liquidated damages. The letters are attached as Exhibits I-XXVIII. A copy of the recommendation as it was sent out for comment is attached to this memorandum. A few writers gave their full (see Exhibits XIX and XXIII) or qualified support (see Exhibits II, III, XIII, XV, XVII, XXI, XXII, and XXVII). Most of the letters contained substantial criticism. The Orange County Bar Association submitted a resolution supporting the tentative recommendation to the Conference of Delegates of the State Bar, but this was opposed by the San Diego County Bar Association on the grounds that the recommendation is tentative only. (See Exhibit XXIV.) We do not know the final disposition of this matter.

The most common objections are that the allowable percentages concerning late payment charges and land deposits are too high, that consumers should be exempted, that residential housing should be exempted, that the burden should not be shifted, that adhesion contracts are not properly dealt with, and that the recommendation is generally pro-lender/seller and anti-consumer/resident/buyer.

The substance of these criticisms is dealt with section by section below.

I. Section 2954.6 - Late Payment Charges

At least two bills have been introduced in this session of the Legislature which are relevant to the part of the recommendation dealing with late payment charges on loans secured by a mortgage or deed of trust on real property. (See Exhibit XXXI.) Senate Bill 304, which has been signed by the Governor, allows mortgage loan brokers to impose a late charge of 10 percent of the

installment due on a loan secured by a mortgage or deed of trust on real property or $5, whichever is greater. The late charge may be imposed only once and a 10-day grace period is provided. The part of S.B. 304 dealing with late charges should be repealed if the proposed Section 2954.6 is enacted.

Assembly Bill 105 provides for a late charge not exceeding 10 percent of the installment due on loans secured by a mortgage or deed of trust on single-family, owner-occupied dwellings. A.B. 105 passed the Assembly (58-0) but, according to a usually reliable source, has not passed the Senate because of opposition from the Department of Consumer Affairs.

As things stand now, there is still a need for legislation in this area.

A. Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n

At the July meeting, the Commission put off consideration of the comments on the tentative recommendation relating to liquidated damages until after the California Supreme Court's decision in Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973). A copy of the decision is attached to this memorandum as Exhibit XXXII.

In Garrett, the court holds that a late charge on an installment payment on a loan secured by real property amounting to two percent per annum for the period of delinquency assessed against the unpaid principal balance is invalid as a penalty under the statutory standard of Civil Code Sections 1670 and 1671 (void unless impracticable or extremely difficult to fix) and case law requiring a "reasonable endeavor to estimate a fair average compensation" for the loss. The court concluded that any late payment charge based on the unpaid balance is punitive and does not represent a reasonable endeavor and, therefore, is void. (Id. at 740.) The court also said that late charges should not be extremely difficult to fix although it might be impracticable

to do so where it is shown that the cost of ascertaining damages is in excess of a reasonable sum agreed to in advance. The court would enforce a liquidated damages clause in such a case where the parties had reasonably endeavored to fix a fair compensation. (Id. at 741-742.)

The holding in Garrett is based on case law and Civil Code Sections 1670 and 1671. Since the recommendation would repeal Sections 1670 and 1671 and make the cases interpreting those sections largely inapplicable, the holding in Garrett does not bear directly on the recommendation. However, Garrett does give an indication of how certain aspects of the recommended provisions might be interpreted by the court. Proposed Section 2954.6(c)--allowing a maximum charge of 10 percent of principal and interest included in the installment where a majority of the installments are each less than $500--would not conflict with the letter of Garrett since the charge found to be void there was a percentage of principal remaining due and unpaid rather than percentage of installment. However, the interpretation of subdivision (b), which in relevant part requires late charges to satisfy the standard of Section 3319 "and all other applicable provisions of law," might very well be affected. Proposed Section 3319 makes liquidated damages provisions presumptively valid unless it is shown that the provision "was unreasonable under the circumstances existing at the time of the making of the contract." The Comment to this section explains that one relevant consideration in determining whether the amount is unreasonable is "the range of damages that reasonably could have been anticipated by the parties." Garrett indicates that late charges under subdivision (b) could reasonably be calculated (although it must be remembered that the court states that it might often be impracticable to do so). Specifically, the court said that the

> lender's charges could be fairly measured by the period of time the money was wrongfully withheld plus the administrative costs reasonably related to collecting and accounting for a late payment. (Id. at 741.)

This standard would probably be applied to late charges under proposed Section 2954.6(b).

B. Ten Percent Is Too High

A frequent comment regarding both late payment charges and land sale deposits is that the allowable charges are too high, and/or that only the actual damages should be allowed. It was said that the 10-percent charge was too high, particularly for the occasional, unintentional delay in payment such as might be caused by going on vacation or a delay in mail delivery. (See Exhibit III.) David Jackson, the attorney for plaintiffs in Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, states that the 10-percent charge is "grossly in excess of what actual damages are in fact." (See Exhibit XI.) He suggests that, on an 8 percent loan where a $200 payment is withheld 30 days, the lender would not be damaged over $2 or $3, but the charge under the proposed Section 2954.6 would be $20. In addition, he argues that Civil Code Section 3302--which 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"--requires the charge to be no more than the interest lost. (See Exhibit XII.) However, Garrett refers to Section 3302 in footnote 11 as follows:

> Damages resulting because of the wrongful withholding of money are fixed by law (§3302) and the other damages resulting because of a borrower's default on an installment, such as administrative and accounting costs, would not appear to present extreme difficulty in prospective fixing.

Hence, Garrett suggests that Section 3302 does not preclude assessing reasonable administrative and accounting costs in addition to the loss of interest. Section 2954.6(c) would be a statutory exception to the application of a strict interpretation of Section 3302. Since there is a conflict, the Comment to Section 2954.6(c) should state that that section is an exception to Section 3302.

Several letters claimed that the 10-percent late payment charge in Section 2954.6(c) would cause all lenders who charge less to raise their rates to that level and, therefore, that it is an undesirable revision. (See Exhibits VII and XII.)

Exhibit XIV suggests that the presumed validity of a 10-percent charge under Section 2954.6(c) be eliminated and that a standard of reasonableness including the touchstone of actual damages should be applied in all cases. This approach would not accomplish the purpose of avoiding expensive litigation over small amounts of damages recognized in the preliminary part of the recommendation and most recently in Garrett.

The passage of S.B. 304 may be taken as an indication that a figure less than 10 percent is unrealistic although, on the other hand, the nonpassage of A.B. 105 indicates that those wishing a lower rate also have significant power in the Legislature.

C. Partial Payment of Installment

Exhibit IX raises the problem of partial payment of the installment due and suggests that, where the borrower pays part of the payment, the late charge should be based upon the amount of the installment remaining unpaid rather than upon the whole payment. (See Exhibit IX, p. 3.) The Commission has previously considered this point and decided that the charge should be imposed if full payment has not been made. This course was chosen because of the difficulty involved in determining how partial payments should be allocated between impound accounts and principal and interest.

D. Notice

Exhibit III suggests that a notice of default be required before the 10-percent late charge is assessed. Similarly, another letter proposes that

the lender be required to send notice before assessment of the late payment penalty since otherwise the "full deterent effect of the late payment charge may well not be felt." (See Exhibit IX, p. 4.) However, the provisions of existing law should be adequate. Section 2954.5 (see Exhibit XXIX) provides for either a written notice after which the borrower has six days to cure the delinquency or a statement of the date when charges will be assessed to be included with the billing for each installment. Subdivisions (b) and (c) of Section 2954.6 both specifically provide that Section 2954.5 must be satisfied.

Exhibit VI suggests that late payment provisions under Section 2954.6(c) (where each of a majority of payments is under $500) should be required to be signed or initialed as is provided in Section 3320 for land sale deposits. This could be provided in the hope that borrowers then would know what charges they are subject to for late payments. However, it may be argued that such a provision is not needed at least in Section 2954.6(c) since the 10-percent figure is a maximum whereas under Section 3320 the five-percent figure is not. What does the Commission wish to do?

E. Risk of Nondelivery

Three letters disagreed with the Commission policy to put the risk of nondelivery of the payment on the borrower under Section 2954.6(c). (See Exhibits II, p. 1; III; and IX, p. 3.) One noted the difficulty with the mail service and suggested that, since the lender did not have to maintain payment offices, he should assume the risk of nondelivery. Another said that lenders are better able to bear the risk since they can utilize insurance schemes and that the imposition of late charges where the borrower has timely mailed the payment does not further the policy of motivating the borrower to make timely

payment since he has done what he could short of hand delivery. (See Exhibit IX, p. 3.) If late paying borrowers in large numbers are truly cautious, they will bedevil the lenders with telephone calls to make sure that the payment has been received, thus increasing the costs to the lenders. This would be avoided if the risk is put on the lender by making payment effective when mailed although, as has been discussed at previous meetings, this opens the way for fraud on the part of unscrupulous borrowers. The Commission may want to reconsider the risk of nondelivery in light of these comments.

F. Default and Waiver

Exhibit XXVII raises the following questions:

> Proposed Section 2954.6(c)(1) requires the lender to apply an installment payment to the current payment while prior installments are still delinquent. If the loan is in default, must the lender accept such part-payment; and, if he does, has he waived the default so that foreclosure cannot be had on the still delinquent payment. If he can and does refuse to accept the current payment, may he thereafter claim a late charge for that installment.

The staff does not think that there is any implied requirement in Section 2954.6(c)(1) that the lender accept payments but, once he does, the payment must be applied to installments currently due in order that they will not become delinquent. No legitimate purpose would be served in applying a payment to a past delinquent installment for which a late charge has probably been assessed. Each delinquent installment is a default, and those remaining unpaid continue as grounds for foreclosure as a matter of other law. See, e.g., Bisno v. Sax, 175 Cal. App.2d 714, 724, 346 P.2d 814, ___ (1959). The staff does not see how the proposed Section 2954.6(c)(1) would imply any alteration of the general rule. Under this section, the default remains on the basis of the previous delinquent installment; if it were left to the discretion of the lender, the payment could be applied to cure the previous delinquent installment

which would result in the current installment becoming delinquent. In both cases, one installment is delinquent and, hence, is a default. The last question raised by the writer is not answered by Section 2954.6. However, it seems obvious to the staff that the lender should not be able to refuse an installment payment and also claim a late charge on that payment. This should be true regardless of whether there is a previous delinquent installment remaining unpaid. It also seems fairly clear that the word "paid" in the first sentence of Section 2954.6(c)(1) precludes assessment of the late payment charge where the payment has been paid, even if refused. If the Commission thinks the language is insufficient in this regard, subdivision (c)(1) could be changed to read "tendered or paid."

G. Lender's Option to Add Charge to Principal

Two writers suggest that the lender should be required to give notice to the borrower before he exercises his option under Section 2954.6(d) to add a late payment charge to principal which has not been paid 40 days after the installment due date. (See Exhibits XVII, p. 3, and XXVII, p. 2.) Notice of the assessment of the original penalty is provided for by Section 2954.5 (attached as Exhibit XXIX) as discussed in part D above; however, Section 2954.5 does not cover the addition of the charge to principal. The staff recommends that it be provided in Section 2954.6(d) that the option is exercisable only after notice to the borrower since it seems equitable that the borrower be informed that the principal is being increased. The borrower could be informed of this option at the time of the original agreement or in the notice required by Section 2954.5, but these alternatives are insufficient since they would not inform the borrower that the option was actually going to be exercised.

Exhbit XVII suggests that, after 40 days, the lender should be able to increase the late payment charge since additional accounting and administrative costs may be incurred. The staff recommends against this course since it would be too complex, the 10-percent charge seems entierely adequate, and the option allows the lender to assess interest on the charge from the time it is added to the principal.

Exhibit XVII also suggests that the late payment charge which is added to principal should become immediately due and payable and that the addition of the charge to principal should not preclude the lender from treating the failure to pay the charge as a default. The staff recommends that no change be made in the policy of Section 2954.6(d). Exhibit XVII further states that the writer did not understand from reading subdivision (d) that, as the Comment says, the lender cannot treat the failure to pay the charge as a default once it has been added to principal. To remedy this ambiguity, the staff recommends that the second sentence of the Comment to subdivision (d) be added to subdivision (d) of Section 2954.6.

H. Usury

Exhibit XXVII states that the statute should indicate whether late charges are interest, handling charges, or forfeitures and suggests that, if they are interest, there may be a usury problem. The staff thinks that labeling the charges as suggested would not accomplish anything; if it should be held that they are unconstitutional interest charges, labeling late payment charges as statutory forfeitures or handling charges would surely not save them.

II. Section 3319 - General Liquidated Damages Provision

A. Adhesion Contracts and Criteria of Reasonableness

Several letters expressed concern about adhesion contract situations. (See Exhibits VII, VIII, IX, X, XIII, XIV, XVII, and XXI.) One letter suggests that the presumption in favor of liquidated damages should apply only where the agreement is negotiated and that this could best be accomplished by amending the existing Section 1671. (See Exhibit XI.)

Other letters suggest that consumer contracts and residential leases should be taken out of the coverage of Section 3319 in order to avoid the adhesion situation. (See Exhibits VIII, p. 2; IX, p. 3; and XXI; see also the discussion of public works contracts in part II, C. below.) Of course, late payment charges in retail sales, real estate loans, and automobile financing are covered by other provisions as the Comment to Section 3319 states; hence, the effect of Section 3319 in the consumer area will be minimal. Some writers would shift the burden to prove reasonableness back on the party seeking to enforce the liquidated damages provision in certain classes of cases.

Another suggested alternative would be to specify some factors of reasonableness in the language of Section 3319 rather than in the Comment--such as the relationship between the parties at the time the contract was made (see Exhibit XXI), whether the contract was a form contract (See Exhibit XVII, p. 2), and the relationship to the actual damages (see Exhibits IX, p. 4, and XIV, p. 2). A listing of factors such as these would be in line with the consultant's study. See Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 144-145 (1972). Apparently, it is widely felt that the standard of reasonableness should guard against abusive adhesion contracts and utilize the standard of actual damages. Furthermore, it is feared that the discussion in the

Comment is inadequate to protect those attacking liquidated damages clauses in adhesion and other contracts. Whether or not the policy of Section 3319 is changed, the Commission should consider listing major elements of reasonableness in the statute rather than in the Comment.

A range of alternatives exist: (1) Existing law (Civil Code Sections 1670 and 1671) could be retained. (2) The recommended Section 3319 could be approved without change. (3) Section 3319 could be approved with a list of factors to be considered in determining reasonableness such as are now listed in the Comment or including other factors. (4) Certain classes of cases such as all consumer transactions and residential leases could be subject to existing law while other cases would be subject to Section 3319. (5) A procedure could be developed whereby the issue of adhesion is first determined; then, if it is determined that the contract is adhesive, the party seeking to enforce the liquidated damages clause would have the burden and, if the contract is not adhesive, the party attacking the clause would have the burden. (6) The consultant's recommendation could be adopted and Section 3319 be revised to adopt the principle of Commercial Code Section 2718 which reads in part as follows:

> 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.

Professor Sweet has adapted Commercial Code Section 2718 as follows:

> 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. [Sweet, supra, at 144-145.]

The staff recommends that the Commission adopt this approach. There would then be no real difference between the standards applicable to liquidated damages provisions in contracts generally and in contracts for the sale of goods. It should be noted that this approach would allow the court to take into account the actual harm caused by the breach, whereas Section 3319 as now drafted provides for the determination of reasonableness solely on the basis of the circumstances existing at the time the contract was made. The burden of proving unreasonableness should still be on the party attacking the clause.

B. Notice Provisions (Section 3319)

Exhibit IV suggests that the party against whom a liquidated damages provision is applied should be afforded notice that he may bring an action to determine whether the amount of the damages is reasonable. Such notices are often provided where there is a special procedure for claiming exemptions. (See, e.g., Judicial Council forms for writ of execution; Section 723.122 of the Recommendation Relating to Wage Garnishment and Related Matters; and Section 512.040 of the Recommendation Relating to the Claim and Delivery Statute.) However, there is no special procedure here, and we are dealing with contract provisions rather than judicial proceedings. The staff thinks that there is no particular need for a notice of the nature suggested, although it might be beneficial especially in consumer situations covered by Section 3319.

Another letter suggests that a statement be included in forms explaining what liquidated damages are since the unsophisticated might not know (Exhibit XIII).

C. Public Works Contracts

Six letters concern public works contracts. (See Exhibits V, X, XX, XXII, XXV, and XXVIII.) They note the different nature of public works contracts resulting from the necessity of the public entity to rely on the competitive bidding procedure and the extreme difficulty of accurately estimating the harm caused by a delay in performance. In almost all cases the amount of the liquidated damages is not negotiated nor adequately estimated. Therefore, it is claimed, the amount is usually too far from actual damages to satisfy the courts under the current scheme of the law. In theory this may be true, but apparently such clauses are usually enforced. See Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 122 (1972). The public entities admit frankly that, in their view, a major purpose of liquidated damages provisions is to get the project done as quickly as possible to avoid the adverse consequences to the public of a delay in public works projects. Hence, letters from public entities tended to support the proposed Section 3319. However, some want it clarified that the section applies to public works contracts and that the lack of negotiation is not significant. One writer suggests legislation of a specific minimum amount in public works and procurement contracts which would be presumed reasonable since he doubts that public entities would make a great effort to satisfy the standard of Section 3319 in order to survive a challenge. (See Exhibit XX, p. 2.)

The staff agrees that the difficulty of estimating damages and the extent of the harm involved in a breach of a public works contract may often be of a greater magnitude than in other contracts, but the staff thinks that such problems are not of a significantly different kind and that the present recommendation is not insufficient in this regard. The staff recommends that the Commission not get involved in this complex problem at this time other than perhaps to make clear in the Comment that the provision applies to public

contracts as well. If the criteria of reasonableness are moved from the Comment to the statute, perhaps it should be provided that the lack of negotiation is not material in such contracts.

Government Code Section 14376 currently provides that state contracts shall contain provisions for penalties for late completion and bonuses for early completion. Cal. Stats. 1973, Ch. 83 (adding Govt. Code § 53069.85 effective January 1, 1974) gives cities, counties, and districts the authority to include similar provisions in public works contracts. The question of the relation between these provisions and Section 3319 is raised. Government Code Sections 14376 and 53069.85 (attached as Exhibit XXX) are somewhat vague; they do not appear on their faces to be a determination that such clauses are necessarily valid. Silva & Hill Constr. Co. v. Employers Mutual Liab. Ins. Co., 19 Cal. App.3d 914, 97 Cal. Rptr. 498 (1971), held that Government Code Section 14376 is a legislative determination that such charges for late completion fall within the language of Civil Code Section 1671 that, to be valid, damages must have been impracticable or extremely difficult to fix. That decision did not say whether the other judicially developed requirements apply--such as that the amount must reflect a reasonable endeavor to estimate probable damages. The Department of Transportation (Exhibit XXVIII) reports that it is content with the requirements of the State Contract Act (including Govt. Code § 14376) and anticipates that Section 3319 will not affect operations under that act.

Should Section 3319 make clear that public works contracts involving clauses under Government Code Sections 14376 and 53069.85 are subject to the rule of reasonableness? Or should such contracts be exempted from the coverage of Section 3319?

One letter concerning public works contracts expresses a contractor's viewpoint. (See Exhibit X.) This writer notes the adhesive nature of the

public works contract and particularly objects to the practice of allowing the public entity to grant or deny requests for time extensions and determine the amount of the penalty to be assessed. In addition, the writer thinks that it is inequitable to allow public entities to exempt themselves from damages to the contractor and limit contractors to obtaining extensions of time. The conclusion of this writer is that no general liquidated damages recommendation should be proposed until the particular problems involved in public works contracts, and construction contracts generally, are solved.

D. Legal Services Contracts

Exhibit I suggests that some attorneys may seek to avoid the holding in Fracasse v. Brent, 6 Cal.3d 784, 494 P.2d 9, 100 Cal. Rptr. 385 (1972), by means of liquidated damages clauses. Fracasse held that an attorney who is discharged with or without cause is entitled only to the value of his services up to the time of discharge and that a cause of action does not accrue under a contingent fee contract until the occurrence of the contingency. The writer does not indicate how he would resolve the problem regarding liquidated damages in retainer agreements, but he suggests that perhaps the entire area of attorney compensation would be an appropriate subject for Commission study.

Professor Sweet writes that, under current law, "legal services, like broker's services, are relatively easy to value, and therefore probably cannot be liquidated." Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 111 (1972). Section 3319 would probably change the result stated by Sweet since reasonableness at the time of contracting would be the only criterion. Fracasse however would conflict with the policy of Section 3319. Fracasse holds that the attorney is entitled only to recovery of the quantum meruit. It should be noted that Fracasse did not deal with a liquidated damages provision.

In a case deciding the conflict between a liquidated damages clause subject to Section 3319 and Fracasse, the court might hold all liquidated damages provisions in retainer agreements to be unreasonable under Section 3319 in order to vindicate the Fracasse holding. However, Section 3319 requires reasonableness to be judged at the time the contract was made which would conflict directly with the actual damages thinking of the court. Perhaps the enactment of Section 3319 would be viewed as limiting Fracasse to situations where there is no liquidated damages provision. If Section 3319 is revised as recommended by the staff, the conflicts with Fracasse would be minimized.

At this time, the simplest courses would be to leave the recommendation as it is or to add a sentence prohibiting liquidated damages in retainer agreements--depending on which way the Commission wants to go. Legislation on attorney compensation would most appropriately be proposed by some attorneys' group or the State Bar.

E. Attorney's Fees

Exhibit XVII (pp. 4-5) raises the question whether the recovery of attorney's fees incurred in enforcing a liquidated damages provision would be precluded by the liquidated damages clause. Unless provided for by statute, attorney's fees are generally not recoverable in the absence of a contract provision to that effect. See 4 B. Witkin, California Procedure Judgment § 116 at 3267 (1971). The staff believes that Section 3319 would not preclude recovery of attorney's fees provided by statute or a properly drafted contract provision; however, if the Commission thinks there is some doubt, then a sentence should be added to Section 3319 or its Comment to make clear that recovery under a liquidated damages clause does not preclude recovery of attorney's fees provided by law or by contract.

F. Anticompetitive Provisions

Exhibit I (p. 2) suggests that a liquidated damages provision might be a subterfuge restraint of trade in violation of federal and state law. The staff suggests that, to remedy this possibility, a sentence be added to the Comment to Section 3319 stating, for example, that Section 3319 does not make valid any practice which is unlawful under the provisions of federal antitrust law or state law concerning restraint of trade (Bus. & Prof. Code § 16600 et seq.) and unfair practices (Bus. & Prof. Code § 17000 et seq.).

G. Commercial Code Section 2718

Exhibit XXI suggests either that it be made clear that Section 3319 does not cover sales of goods or that the test of Commercial Code Section 2718 be changed to that of Section 3319. If Section 3319 is altered as suggested by the staff in part II, A. below, this presents no problem, for Section 3319 would then conform to Section 2718. As it now stands, the Comment to Section 3319 states in the last paragraph that Section 2718 is not affected. If the substance of Section 3319 is not changed, the statement in the Comment should be given force in the statute by adding "except as otherwise provided by law" to Section 3319. This would also solve any problems of conflicts with other sections listed in the last paragraph of the Comment to Section 3319.

III. Section 3320 - Land Sale Deposits

A. Single-Family Dwellings

Several writers suggest that Section 3320 be restricted in some way such as by excluding single-family residential dwellings or transactions involving no more than four units. (See Exhibits I and XV.) The Commission has previously considered and rejected similar suggestions.

B. Five Percent Is Too High

A related comment is that the five-percent figure is too high, particularly in transactions involving residential housing. (See Exhibits I, p. 2; II, p. 2; VIII, p. 3; XV; and XXVII.) And the suggestion is made that the assessment of actual damages is the only appropriate course. (See Exhibit VIII, p. 3.) On the other hand, one writer suggests that the initial figure should be 10 percent and that the longer the house is held off the market, the higher the percentage figure should go. (See Exhibit XVII, p. 4.)

In Exhibit XXVI, Professor Sweet states that the amount of the deposit is likely to be negotiated, thereby minimizing adhesion objections, and that buyers may protect themselves by conditioning performance on the occurrence of some event. In addition, he makes the point that, in a declining market, the amount of the liquidated damages is also a limitation on the buyer's liability. Exhibit XXVII states that the five-percent figure will probably become a minimum charge.

In view of the arguments and objections on both sides, the five-percent figure is probably the most acceptable.

C. Installment Land Contracts

In Exhibit XVIII, Professor Bernhardt asks what "contract for the sale of real property" includes and suggests that either Section 3320 should exclude installment land contracts or "deposit" should be defined to include only the amount of money paid at the time the offer is made or the contract is signed. The problem apparently is that the unsophisticated buyer in an installment land contract situation will find the seller claiming that the entire amount paid before title passes is a deposit. Of course, as Section 3320 is now drafted, the buyer will have initialed a clause saying that the deposit is intended to be liquidated damages and, if the amount of the deposit is over five percent,

it is subject to the test of reasonableness. However, the staff notes that Section 3320(a) does not specifically require the clause to state the amount of the deposit--this could foster deception. If the amount of the deposit is over five percent, the buyer will have the burden of showing unreasonableness.

Installment land contracts are apparently widely disapproved. See Hetland, Land Contracts in California Land Security and Developement § 2.20 (Cal. Cont. Ed. Bar 1960); Moore and Sturhahn, Purchase Price and Financing in California Real Estate Sales Transactions §§ 9.3-9.5 (Cal. Cont. Ed. Bar 1967). Hence, it is tempting to follow the first suggestion of Professor Bernhardt to remove installment land contracts from the coverage of Section 3320. However, unless a provision were added which said that liquidated damages provisions in such contracts are invalid, the general provisions of Section 3319 would seem to apply, the minimal protection of requiring a separate clause, initialed or signed, would be lacking, and the presumptive validity of a five-percent deposit would be inapplicable.

The staff thinks that the second course of restricting the definition of "deposit" to mean the amount paid at the time the offer is made or the contract is signed should be followed. In addition, it should be made clear that the required clause must state the amount of the deposit.

D. Specific Performance

Exhibit XXI suggests that it be made clear that the right to specific performance of a land sale contract is preserved. The seller's right to specific performance is discussed briefly on page six of the preliminary part of the recommendation and is referred to by the Comment to Section 3320. The writer suggests, however, that, in view of the importance of the right to specific performance to the buyer, the statute should state that use of a liquidated

damages provision will not deprive either party of their equitable remedies. The staff thinks this matter should remain in the Comment.

IV. Miscellaneous

A. Conflict With Residential Landlord and Tenant Act

One letter points out that there are conflicts between Section 1951.5 of the recommendation and A.B. 1202, the Uniform Landlord Tenant Relation Act. At this time, A.B. 1202 has been held by the Assembly Committee on the Judiciary without recommendation. The staff recommends that no changes be made in the tentative recommendation on this ground until such time as A.B. 1202 seems sure of passage.

B. Real Estate Leases

Exhibit XXVII (p. 1) suggests that real estate leases be separately treated and that liquidated damages clauses therein be required to be initialed. The Commission has previously considered and rejected separate treatment for real estate leases.

C. Drafting

Exhibit XVII suggests a lengthy alternative to Section 3319 to remedy the writer's suspicion that there is a technical problem with referring to the "requirements of Section 3319" in Sections 2954.6(b) and 3320(b). This is related to the problem of having the elements of reasonableness discussed in the Comment to Section 3319 instead of listed in the statute as discussed in part II, A. This problem will not exist if the criteria of reasonableness are stated in the statute.

Respectfully submitted,

Stan G. Ulrich
Legal Counsel

Memorandum 73-47

EXHIBIT I

SILBER & KIPPERMAN
ATTORNEYS AT LAW
802 MONTGOMERY STREET
SAN FRANCISCO, CALIFORNIA 94133

MICHAEL D. SILBER
STEVEN M. KIPPERMAN

TELEPHONE: (415) 788-8870

March 21, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

RE: TENTATIVE RECOMMENDATION RELATING TO LIQUIDATED DAMAGES

Dear Sirs:

Although I received the above-entitled recommendation, I did not receive the background study. Please forward that document to me.

With respect to the recommendation, I do have some comments:

(1) In light of the California Supreme Court decision in Fracasse v. Brent, 6 Cal. 3d 784 (1972), I am sure that if liquidated damages are more liberally allowed that some attorneys may, in an effort to avoid the impact of Fracasse, seek to include in written retainer agreements that in the event of a breach of the contract by the client that liquidated damages to the attorney may be permitted. Fracasse at least did not speak precisely to the point of whether some sort of damage provision or compensation arrangement was enforceable when the client discharged an attorney (albeit wrongfully) where a provision therefore was actually in the contract. Perhaps some statutory language could be included to make clear a legislative intent with respect to that kind of situation. Actually, perhaps an entire chapter on attorney compensation agreements would be an appropriate subject for review.

(2) With respect to "land sale deposits", I think that you should exempt the sale of single-family residential dwellings for several reasons. As a matter of fact, we all know that deposit receipts for such sales are so adhesive as to virtually negate any meaningful bargaining over standard terms. A liquidated damage provision is most certainly going to be included as a standard term and will probably not be understood by anyone who reads the documents if, indeed, many people do read them. Moreover, a presumptive validity of five percent being permitted in such transactions seems quite excessive. That would mean that a defaulting buyer would be liable for $2,000 on a $40,000 house when, in fact, the seller generally has another buyer ready in the single-family dwelling context, or can secure another buyer quite readily.

(3) In the context of partnership agreements or exclusive-dealer agreements of various kinds, a liquidated damages provision may be simply a device to avoid prohibitions on anti-competitive clauses found both in Federal law and in the business and professions code. Perhaps some consideration should be given to this problem where excessive liquidated damage provisions may be inserted. Even though liquidated damage provisions are going to provide for high damages, it is nevertheless going to be a difficult proof problem (as a practical matter) to have them held invalid given the momentum of a legislative declaration that such provisions should be encouraged as your Recommendation could be fairly construed to be. Perhaps some language should be added to the effect that nothing contained in the liquidated damage statutes would in any way prevent a court from stri king down even a reasonable (in amount) provision if it were found to be anti-competitive in any way.

(4) Section 8 (the effective date provision) really seems to me to be inconsistent with the whole thrust of the Recommendation. If the thrust of

the Recommendation is that liquidated damage provisions should be encouraged and that one of the factors indicating their unreasonableness is whether they are contained in contracts of adhesion, then why defer the effective date only so that the adhesive contracts can be modified to include such provisions. That is really the only benefit of deferring the effective date as stated in the comments thereto.

Very truly yours,

STEVEN M. KIPPERMAN

SMK/bah

Memorandum 73-47

EXHIBIT II

RICHARD G. RANDOLPH
ATTORNEY AT LAW
520 SOUTH EL CAMINO REAL
SAN MATEO, CALIFORNIA 94402
TELEPHONE (415) 342-4900

March 22, 1973

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

Dear Mr. DeMoully:

I have reviewed the tentative recommendation of the Commission relating to liquidated damages. I have two comments to make about the proposal.

In general, I think the approach of the Commission will make a much needed policy declaration and produce adequate guidelines with which to establish the criteria of liquidated damages. However, with respect to the late payment charge for secured loans, I am troubled by the inclusion in your proposed Section 2954.6 of the statement that the installment payment shall be considered paid as of the date it is received by the lender. I am not sure how to overcome my reluctance to accept this statement, but I do feel that as a cost of doing business and to foster the use of mailed payments as opposed to maintaining payment offices, the lender should assume the risk of non-delivery by the U.S. Postal Service.

In this day of our current mail service, a payment made quite timely could be delayed sufficiently in the mails either not to arrive or to arrive after the delinquent date. Our entire notice system is predicated upon notice having been made at the time of depositing postage prepaid with the U.S. mail, and I think it would be a preferable instance in this case also to provide that the borrower shall have completed his obligation with timely deposit in the U.S. mails.

I also feel that the provision for a liquidated damage clause in the Standard Real Estate Purchase Agreement is established at an excessive amount. You say that the liquidated damages shall be deemed reasonable if the amount does not exceed 5% of the total purchase price in the contract. Taking a hypothetical home purchase at $40,000.00, that would mean that the liquidated damages could amount to as much as $2,000.00. On the other hand, the $40,000.00 home capitalized at 8% is $260.00 a month. It seems to me that a purchaser who has cost the seller a month of time for securing a second purchaser is being unduly penalized to pay an amount almost equivalent to ten times the capitalized earnings of the cost of the property to be purchased.

Again, I am full of complaints and not very full of answers. However, might I suggest that the liquidated damages not exceed the purchase price capitalized at 10% on a per day basis from the time the deposit receipt is signed until the default is made.

Taking my example of the $40,000.00 home, the penal sum on a 360 day year would be $11.11 per day or $330.00 for a 30 day month which would seem to me to be a more reasonable equation of the "damages" that would accrue to the seller.

In all events, I think the industry would welcome the clarification that is intended by your revision.

Very truly yours,

RICHARD G. RANDOLPH

RGR/pe

Memorandum 73-47

EXHIBIT III

PALLEY & SCHWARTZ, INC.
ATTORNEYS AT LAW
SUITE 800
1880 CENTURY PARK EAST
CENTURY CITY
LOS ANGELES, CALIFORNIA 90067

LAWRENCE I. SCHWARTZ
MICHAEL R. PALLEY

AREA CODE 213
277-2971 - 879-2370

March 28, 1973

Cal. Law Revision Comm'n
School of Law
Stanford Univ.
Stanford, CA. 94305

Re: Liquidated Damages - Tentative Recommendation

Gentlemen:

My principal recommendation would be that you give consideration to a requirement of a notification of default, and a few days to pay thereafter, before permitting the levying of the relatively heavy late charges permitted under proposed § 2954.6 (c).

I also fail to understand why the reasonableness test, incorporated into (b) is not also incorporated into (c).

I also believe that the type of late charges permitted in that section are excessive for an occassional, unintentional delay in payment, as frequently is occassioned by vacation, mail delays, etc. Thus, my suggestion in the first paragraph, above.

With the above reservations, I think your Tentative Recommendation reflects good thought, and will improve and clarify this area.

Very truly yours,

MICHAEL R. PALLEY
of PALLEY & SCHWARTZ, INC.

MRP/se

Memorandum 73-47

EXHIBIT IV

100 Cresta Vista
San Francisco, California 94127
March 28, 1973

California Law Revision Commission
School of Law
Stanford, California 94305

Sirs:

Your recent recommendation regarding the ligitimization of reasonable liquidated damages clauses was read with interest and occasions one comment. To wit: While it would seem appropriate to allow courts to enforce reasonable provision for liquidated damages (for reasons relating in part to reducing trial time and expense), it is suggested that it be required, as a condition to subsequent enforcement of such a clause (whether reasonable or unreasonable), that the clause contain wording reading (more or less) as follows:

> "If, when demand for damages is made, the party of whom they are demanded deems the amount demanded to be unreasonable, that party may bring action to have a court determine whether the amount is reasonable."

The point of this wording is not to provide the party of whom damages are demanded with an otherwise non-existing right to put the other party to his proof, but simply to insure that the damaging party (the recipient of the demand for liquidated damages) is made aware that he is not utterly at the mercy of the party demanding payment and does have this one limited right to contest reasonableness. Otherwise, seen here, it is entirely likely that the party upon whom demand is made will conclude, by his agreeing to the provision, that he not only cannot contest the amount of damages (viz., try to prove the other's actual damages), but can't even resort to court for this one, new, limited purpose of contesting reasonableness. In a word, if the right is limited, but the party with the one lingering right to prove unreasonableness is not expressly informed that he has that right, the right well might, in practice, never exist. The point would be that, if all rights (as to damages) but one are taken away, the party should at least be clearly reminded, within the instrument itself, that he has that one right.

This could all no doubt have been more succinctly stated, but perhaps you'll bear with the verbiage and understand what's being driven at. Thank you kindly.

Yours truly,

F. W. T. Hoogland

Memorandum 73-47

EXHIBIT V

CITY OF FRESNO
CALIFORNIA
WORLD CAPITAL OF AGRIBUSINESS

OFFICE OF THE CITY ATTORNEY

CITY HALL • 2326 FRESNO STREET • FRESNO, CALIFORNIA 93721
PHONE 266-8031 • AREA CODE 209

March 29, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Subject: Liquidated Damages

The undersigned has reviewed the tentative recommendation relating to liquidated damages. We comment on the proposed section 3319 (new).

Public entities have particular problems with liquidated damages. Most such clauses are in contracts upon which calls are made for bids. There is not much room in a competitive bidding procedure to negotiate on liquidated damages. Negotiation probably never occurs. The City of Fresno did write into its general specifications that negotiation could be held on this specific clause prior to submission of bids, but so far no contractor has requested negotiation on the point. The reason may be obvious, if he negotiates for lower liquidated damages, would he be the lowest bidder?

When there is no bilateral discussion, the amount of liquidated damages, being an unilateral guess, will almost never be near enough to actual damages to satisfy the courts under the present law. Thus when the courts place great weight upon the actual harm caused by the breach, public entities who must carry out competitive bidding are likely to be the parties most harmed by the rule of law. Further, cities do in fact establish liquidated damages with the intent (usually unexpressed) of endeavoring to get the work done soon in order to protect the public against the consequences of delay. Blocking a main street to a downtown shopping district at Christmas time, delaying the opening of a Convention Center, the blocking of any street, delay in construction of a tennis court or golf course past the date of final play-offs, all such and similar events can cause considerable harm to the public which cannot be expressed in dollars. As liquidated damages are desired to compel performance on time, when the courts say that they must be related to actual provable cash damages, to that extent the public entities are left afield and unprotected under the law on liquidated damages. (The undersigned researched this

matter several times, to determine whether or not the loss to the public could be used even though it is not provable in dollars. The only case he found on the point was the Six Companies case, however, that case was reversed on other grounds and has little authority today. See Six Companies Case, 110 F 2nd. 620, reversed 311 U.S. 730, 85 L. Ed. 425.)

For the above reasons, we believe all public entities would welcome and encourage the adoption of Section 3319, or closely similar provisions.

In your comment to the section I suggest you add a third paragraph to read somewhat as follows:

> To the extent that owners, particularly public entities, do or are required to award contracts after competitive bidding, the present law on liquidated damages does not as a practical matter mesh with the competitive bidding process when such law indicates (in Section 1671) that the parties are to negotiate the liquidated damages provision, when, under competitive bidding, no such negotiation occurs. Further, to the extent that an early completion of the job is in the public benefit, then to the extent that it is delayed the general public will be harmed; however, such harm is rarely measurable in dollars. Thus the present law allows the contractor to delay if the public entity cannot prove the public loss in dollars.

SPENCER THOMAS, JR.
City Attorney

Alan D. Davidson
Assistant

ADD:rs

Memorandum 73-47 EXHIBIT VI

STATE OF CALIFORNIA
COURT OF APPEAL
SECOND DISTRICT—DIVISION FOUR
905 STATE BUILDING
217 WEST FIRST STREET
LOS ANGELES 90012

ROBERT KINGSLEY
ASSOCIATE JUSTICE

March 29, 1973

California Law Revision Commission
School of Law
Stanford, Calif. 94305

Gentlemen:

I have read with interest the Tentative Recommendation Relating to Liquidated Damages. I have only one suggestion to make and that deals with the matter of "late" charges on real property loans.

As the text of your supporting memorandum points out, the ordinary small borrower is concerned chiefly with the interest rate and the size of installment payments; his attention is not directed to the late payment provisions. In the case of damages for breach of a contract of sale, you require a special clause, specially signed or initialed. Why not do the same for the late payment provision (excepting the over $500 cases for which you provide a separate treatment anyway)? This would, at least warn the borrower of the charge to be incurred even though (since the home-loan cases are almost always contracts of adhesion) he may have no real choice but to assent.

Sincerely,

Robert Kingsley

RK:mr

Memorandum 73-47 EXHIBIT VII

RALSTON, SMITH & SULLIVAN
LAWYERS

TELEPHONE 213/380-8650
CABLE: LAWCORP

505 SHATTO PLACE
LOS ANGELES 90020

April 4, 1973

OUR FILE NUMBER

California Law Revision Commission
School of Law - Stanford University
Stanford, California 94305

Re: Tentative Recommendation relating to
Liquidated Damages

Gentlemen:

The Commission's study notes the potential oppressive use of liquidated damages provisions although the proposed legislation simply fails to contain any safeguards.

Proposed Civil Code Section 2954.6 will, in effect, legislate a fixed rate for late charges and thereby effectively deprive the consumer of the judicial protection which is now available.

Proposed Civil Code Section 3319 is particularly desirable with respect to negotiated agreements. I suspect, however, that with respect to contracts of adhesion, and perhaps preprinted form agreements generally, it will become a vehicle of oppression.

The basis for the Commission's recommendation with respect to liquidated damage provisions in leases is not stated. Is there a difference between a commercial and a residential lease ?

In summary, it would be desirable to amend Civil Code Section 1671 to permit liquidated damages in the case of a negotiated agreement.

Very truly yours,

Austin T. Smith

ATS:jm

JOEL S. AARONSON
EXECUTIVE DIRECTOR
PATRICK O. MEISSNER
ALBERTO SALDAMANDO
AVIVA K. BOBB
PHYLLIS W. ELIASBERG
PATRICIA M. TENOSO
JAMES R. TUCKER
VICTOR BROWN
REGINALD H. SMITH FELLOW
CHARLES PEREYRA-SUAREZ
LEGAL INTERN
PARAPROFESSIONALS:
JOSEPH MATTHEWS
ASSOCIATE DIRECTOR
JAMES CRUZ
HUMBERTO LOPEZ
TIM SISSEL
BERNARD McNEALY

Memorandum 73-47 EXHIBIT VIII

SAN FERNANDO VALLEY

NEIGHBORHOOD LEGAL SERVICES, INC.

13327 VAN NUYS BOULEVARD, PACOIMA, CALIFORNIA 91331

896-5211

April 4, 1973

California Law Revision Commission
Stanford University
School of Law
Stanford, California 94305

Re: Tentative Recommendation
Relating to Liquidated Damages
Comment

Gentlemen:

Commenting on your above proposed legislation I believe the recommendation's effect on consumers who are already saddled by hidden penalties and assessments would not only be to sanction some of them by law, but would make these burdens heavier in regard to actual amounts.

I believe that the present sections (C.C. 1670 and 1671) more adequately protect the consumer than your legislation would.

To begin with, your rationale seems to be to avoid Section 2718 of the Commercial Code as requiring litigation. May I point out that practically, liquidated damages are written into a contract usually adhesive in effect, and the burden usually falls on the consumer to litigate. The "risk exposure" which you cite on page 2, and the unwillingness to rely on the judicial process, the fear of insufficient considerations by the court for "excuses to nonperformance" or the court's being "unduly sympathetic to claims of the opposing party", the court's hypothetical "prejudice" against contract breach, can only serve the interests of the lender or seller and not of the consumer. This rationale not only serves but one side of the consumer contracts but unnecessarily belies the court's real concern about predatory business practices and its real and sole function, the administration of justice.

You should limit these provisions, if you feel the above rationale is justified, to purely commercial transactions, for the consumer is already hounded by hidden late charges, liquidated damages

provisions which are truly penalties, and a host of other hidden costs. The parties to a contract may feel that a true agreement in advance may avoid future litigation, but I would only comment that the consumer rarely litigates unless his back is to the wall, and then he must litigate a contract which he never really had any choice about -- A car dealer will never sell a car on a contract not printed by him, a hospital will never admit a patient unless their printed contracts are signed. This is a fact of our consumer life that your proposed legislation seems to totally ignore.

My office and myself as an attorney handled hundreds of so called "contract disputes" concerning earthquake repairs, after the 1971 earthquake in the San Fernando Valley. These "contracts" usually called for "liquidated damages" of 20%. People who received SBA earthquake loans of three to five thousand dollars, without the Civil Code Section and Commercial Code Section which you would do away with, would have had to pay $600.00 to $1,000.00 for the priviledge of having someone come to their house and spending 20 minutes giving them an estimate as to the costs of required repairs. Under your rationale, the contractor and the homeowner would have "agreed" that such percentages were the actual amount of loss for non-performance. I do not believe your rationale fits this situation or a plethora of other consumer contracts. I do not agree that "liquidated damages will provide at least as just a result as a court trial". We would invite you or any one of your staff to come and inspect our files dealing with these home repair contracts alone.

I find little solace in your recommendation which seeks to avoid oppressive adhesion contracts by placing the burden on the consumer to show that they are unreasonable. And to preclude consideration of the damages actually suffered would make such a burden extremely difficult to carry. How else can a party show unreasonableness? One is left with the nothing but a matter of opinion for the judge with little or nothing to base any real judgment upon.

I find the zeal in attempts to avoid litigation, the only rationale consistently appearing in the recommendation, would place so heavy a burden on the consumer that I must emphasize that in my opinion, the avoidance of litigation never justifies doing away with justice or the tools of justice. The consumer should be protected to the fullest extent of the law, in light of the heavy reliance on adhesion contracts. Not even a member of your commission could buy a car or a home without having to submit to an adhesion contract.

The problem does not lie only with home repair or automobile contracts. (And it would take little imagination to think of situations where even car sales would have "liquidated damages" provisions for

repossessions, late payments, costs of re-sale, etc.) I was also interested and agree that there is a problem with deposits for the sale of homes and late payments to lenders.

By contract, sellers of homes could impose a greater penalty in actual amounts than they now impose on buyers. Many people can barely afford to put money down on a home, wait for escrow to close, and find something wrong with the house or in the title. Your language "if the purchaser fails to satisfy his obligation to purchase the property" would again place the burden on the consumer, usually at the mercy of real estate brokers, to litigate merely to recover his deposit. If the Small Claims jurisdictional amount were $1,000.00 this might not be so bad. But under your rationale, a consumer would have to spend most of his deposit on legal fees to recover only a percentage of it, even if he were totally justified in refusing to purchase the property. And, many deposit agreements make no representations or warranties as to the condition of houses, and hidden but serious defects in the house may not be discovered upon the first or second viewing. And many houses are now sold "as is" as far as the seller is concerned, and if a lender refuses to finance because the price has been inflated or the home is not worth the asking price because of termites or for whatever reason, the buyer is still bound by contract to purchase it or lose 5% of the purchase price (for you can be sure that if a 5% liquidated damages provision is set as a maximum, this will become the standard in every printed deposit agreement in this State). This would mean that for a house for which the asking price is $20,000.00, a buyer would lose $1,000.00. If one can only afford a $20,000.00 home, one cannot afford to lose $1,000.00, and much less spend $500.00 in legal fees to recover it.

As to your recommendation concerning late charges by lenders of real property loans, I can only ask you to read more carefully the results of the survey conducted by the Assembly Finance and Insurance Committee and the case you cite wherein after 5 years of payment, where the principal unpaid balance on a loan was for $1,400.00, the borrower still owed $1,321.82. This, coupled with the fact that foreclosure as a matter of practice occurs 60 days after default in California, should indicate to you who needs protection. I could only suggest that the State adopt VA or FHA standards, on the sums which is delinquent, that is, on only that amount remaining delinquent. It would be interesting to find out what, if any, <u>actual</u> damages are occasioned by late payments, but you apparently are <u>not interested</u> in that kind of inquiry.

I cannot help to note that although I did not graduate from such a prestigious University as Stanford, I was taught that damages should be somewhat proportional to the wrong. Yet if your

recommendations become law, every adhesion contract in this State will include provisions for liquidated damages, much to the detriment of the consumer, which will not be based on actual damages but based on what sounded reasonable to the persons who drafted the legislation. I would strongly urge that present legislation be kept in effect and allow the courts to decide what is reasonable and what is not based on a showing of actual damages.

What the Commission might do is set up an alternative system of arbitration which could become mandatory by contract. In fact, I would suggest to the Commission that they look into the feasability of establishing an administrative board which could arbitrate this and other matters along the lines of the hearing boards already established in administrative departments as an alternative to litigation.

Respectfully submitted,

ALBERTO SALDAMANDO
Attorney at Law

AS:pmc
cc - Brian Paddock

Memorandum 73-47 EXHIBIT IX

WALTER R. SEVERSON
JAMES B. WERSON
NATHAN R. BERKE
KURT W. MELCHIOR
ERNEST Y. SEVIER
EDMUND T. KING II
RANSOM S. COOK
ROBERT L. LOFTS
ROBERT V. MAGOR
DENNIS M. TALBOTT
BERNARDUS J. SMIT
FRANK J. GALLAGHER
NICHOLAS S. FREUD
RICHARD B. SCHREIBER
ROGER S. MERTZ
GEORGE T. LENAHAN, JR.
DAVID L. OLSON
D. RONALD RYLAND
J. MARK MONTOBBIO

SEVERSON, WERSON, BERKE & MELCHIOR
ATTORNEYS
ONE EMBARCADERO CENTER · SAN FRANCISCO, CALIFORNIA 94111

RANDELL LARSON
(1893-1968)

GEORGE L. BULAND
ARTHUR T. GEORGE
COUNSEL

TELEPHONE
AREA 415
398-3344

April 11, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Recommendation Relating to Liquidated Damages

Dear Commission:

I believe that the Commission's recommendation that liquidated damages provisions be legitimized in almost every circumstance goes far beyond permitting such clauses in situations where they serve a valuable function. While the trend in commercial transactions has been toward greater recognition of the need for liquidated damages clauses, in consumer transactions the trend has been quite the reverse. The Commission's recommendation codifies the trend in the commercial area but totally ignores the consumer problems.

Where bargaining power is roughly equal and where adhesion or form contracts are not involved, liquidated damage provisions may well serve a useful function. However as the Commission's own discussion of late payment charges in connection with real property loans demonstrates, liquidated damage provisions in the consumer area are subject to wide abuse. Consumers do not ordinarily contemplate the possibility of breach and are therefore unlikely to negotiate over the terms of liquidated damage provisions. Furthermore, even were consumers to be interested in such matters, they lack the bargaining power necessary to effect a change in such provisions. Nor can one rely upon the good faith of those dealing with consumers to avoid misuse of liquidated damages. Again the experience with regard to late payment penalties is instructive. Furthermore, experience with the waiver of express and implied warranties in the consumer area, with attorney's fees provisions in rental leases, with waivers of tort liability, and the like all well demonstrate

that the benevolence of those dealing with consumers affords little protection for the consumers' rights.

That the Commission should ignore the consumer problems inherent in liquidated damages provisions is all the more peculiar in that the background study at page 10 cites Civil Code Sections 1803.6 and 2982 both of which place severe restrictions on late charges in the consumer area. Moreover consideration should be given to the provisions of the Uniform Consumer Credit Code and the Uniform Landlord Tenant Relations Act, which protect consumers against the abuse of liquidated damages. These special provisions dealing with liquidated damages in the consumer indicate a growing consensus that such provisions are so subject to abuse that they cannot be permitted. The Commission should follow this trend of law and limit the validation of liquidated damages to non-consumer transactions.

I also disagree with the Commission's conclusion that real estate lenders need to be able to charge late payment fees in excess of the damages they suffer from such late payments. Real estate lenders are already favored creditors of any consumer in that they have security for their loans. The unsecured creditors of consumers are in a far worse position which the Commission's recommendation would further deteriorate. The statement at page 10 that "[w]ithout such delinquency charges at relatively high levels, a borrower may let his mortgage payments slide while making other pressing debt payments " exemplifies the Commission's unfortunate preference for mortgage lenders over other creditors of the consumer. If a consumer cannot meet all his obligations, there is no reason why a secured lender such as a mortgagee should be preferred over unsecured creditors in the distribution of the inadequate assets. Indeed, quite the opposite approach should be taken. The mortgagee may always resort to his security whereas other creditors must rely upon the income and unpledged assets of the borrower. In short, there is no reason to give real estate lenders a double preference.

In addition, if late charges are permitted in excess of the actual damages suffered, there is absolutely no reason why real estate lenders should reap the benefit of such penalties. Again the payment of such fees to a real estate lender may prejudice the rights of other creditors also

since the reason for the penalty is a supposed public policy in favor of encouraging prompt payment of real estate loans, the penalty should be used to benefit the public rather than to line the pockets of the lender. There are, of course, numerous ways such penalties could be used in the general public interest, and it would seem to me appropriate to funnel such penalties into a common fund to be disbursed for such public ends.

Turning to the specific provisions recommended by the Commission, I would first note that Civil Code Section 1951.5, as the Commission would amend it, appears to apply to all leases of real property. Assuming that the Uniform Landlord Tenant Relation Act, which is now before the state legislature, is passed,the provisions of that act and Section 1951.5 would clearly conflict. In line with my general comments suggesting that liquidated damages provisions be permitted only in non-consumer transactions, I recommend that Section 1951.5 be amended so as to exclude leases of real property for the purpose of residence .

In addition to my general comments regarding late payment charges, I suggest tnat the proposed Civil Code Section 2954.6 (c)(1) be amended so as to provide that installment payments shall be paid as of the date the payment is received by the lender or placed in the United States mail, whichever is earlier. There is no reason why borrowers should bear the risk of bad delivery of the mail; lenders may far more easily spread the risk through appropriate insurance plans. Furthermore, charging a late payment fee where the borrower has timely mailed his installment serves none of the purposes for which a late payment charge is exacted. Clearly the imposition of such charges will not motivate the borrower to make mortgage payments promptly since by hypothesis his payment was timely made but for tne neglect of the post office.

The proposed Section 2954.6(c)(2) should also be amended to encompass the situation of a partial payment of the installment. Where only a portion of the installment is overdue, the late charge should not exceed ten per cent of the amount of principal and interest overdue. As presently drafted, the section would permit the late payment charge to be based on the entire principal and interest of the installment payment, even that portion which had been timely paid.

I would also suggest that the lender be required to send the borrower a notice prior to exaction of the late payment charge. Otherwise, the full deterent effect of the late payment charge may well not be felt. Unless the borrower knows that his late payment will result in added expense to him, the exaction of the late charge will not encourage his prompt payment.

In line with the general comments stated above, I recommend that the proposed Civil Code Section 3319 be amended to exclude consumer transactions. In addition, the section should be amended to give courts some notion of the criteria to be weighed in judging whether a liquidated damage provision is unreasonable under the circumstances existing at the time of the making of the contract. For example, the section should provide that a court ruling upon such matters consider the relative bargaining power of the two parties and whether the liquidated damages provision was a portion of a form or an adhesion contract, whether the amount of damages provided bears a reasonable relationship to the damages which could have been anticipated at the time of the contract, and similar matters.

The views expressed in this letter are those of the writer, and do not necessarily reflect the views of Severson, Werson, Berke & Melchoir. Please be sure that your records reflect my change of address to that given above.

Sincerely yours,

Jan T. Chilton

JTC/m

Memorandum 73-47

EXHIBIT X

GRANT & POPOVICH
ATTORNEYS AT LAW
SUITE 520
1901 AVENUE OF THE STARS
LOS ANGELES, CALIFORNIA 90067
TELEPHONE (213) 879-1236

April 12, 1973

California Law Revision Commission
School of Law
Stanford, California 94305

Re: Tentative Recommendations Relating to Liquidated Damages

Gentlemen:

I would like to call your attention to an important area of the law which has, apparently, been completely overlooked in the tentative recommendations relating to liquidated damages, namely, the use of such provisions in construction contracts, and, particularly, public works construction contracts.

The typical construction contract provides for liquidated damages based on a daily assessment in the event the contractor fails to perform within the time stipulated in the agreement. In private works contracts the amount of the liquidated damages may be the subject of bargaining by the parties if the parties have relatively equal bargaining power. Where the parties to a private works contract do not have relatively equal bargaining power, and in all cases where public works contracts are involved, the owner of the project arbitrarily inserts an amount that will be assessed as liquidated damages in the event that the contractor fails to complete performance within the time specified in the contract. The amount inserted, in our experience, has been such sum as the owner of the project feels is sufficiently large to keep the contractor "on his toes" during performance. The entire basis upon which a valid provision for liquidated damages depends, namely, that the parties have made a reasonable endeavor to estimate actual damages has little relevance in actual practice to private works construction projects and no relevance whatever to a public works construction project.

It should be further noted with respect to public works construction projects that the agreement which the successful bidder will be required to sign is set forth in the documents submitted to prospective bidders. There can be no modification of the contract terms after the successful bidder has been ascertained because such modification would be in violation of the rules governing competitive bidding on public works projects. The sole bargaining power of the contractor in such cases is limited to the unsatisfactory election as to whether he will submit a bid on the project, and where, as at the present time, the public works construction industry is severely depressed, the necessity of bidding upon all work available for bid has deprived the contractor of even that limited freedom of choice.

Another problem involved in the assessment of liquidated damages in construction contracts is the arbitrary assessment of such damages by the owner. In virtually all construction contracts the contractor is entitled to an extension of time for bad weather, strikes, change orders, and other reasons detailed in the contract documents. The owner of the project will usually delay passing upon requests for extension of time until the project has been completed. The owner will then unilaterally determine the extensions of time to which the contractor is entitled, and there will be withheld from the contractor's final payment the amount of liquidated damages that the owner has determined should be assessed. In many instances the amount involved does not warrant the cost of litigating whether there was a proper basis for the assessment of liquidated damages and, if so, the proper amount to be assessed. The inequity of such unilateral determination of liquidated damages by the owner is aggravated by provisions commonly found in such contracts relieving the owner from liability for damages which the owner or the architect may cause and limiting the contractor's remedy to an extension of time for performance provided, in most instances, the contractor has requested such extension of time for performance within the very limited period of time stipulated in the contract. It would seem that equity and fair dealing should mandate the invalidation of a provision for liquidated damages where the owner is relieved of liability for damages in the event that the owner delays the contractor.

I do not believe that any recommendation in general form relating to liquidated damages should be made until such time as there has been a careful consideration of the problems involved in the use of liquidated damage clauses in construction

contracts. There are many inequities and abuses in the use of such clauses in both public works and private works construction contracts which should be studied before new legislation is adopted that would probably result in perpetuating the present unsatisfactory conditions for many more years.

Very truly yours,

GRANT & POPOVICH

Irvin Grant

IG:bk

Memorandum 73-47

EXHIBIT XI

DAVID G. JACKSON
ATTORNEY AT LAW
33 EAST HUNTINGTON DRIVE, SUITE 6
ARCADIA, CALIFORNIA 91006
445-2411

April 16, 1973

Law Revision Commission
c/o School of Law
Stanford University
Palo Alto, California

Gentlemen:

On March 21, 1973, the Los Angeles Daily Journal published an article concerning a proposed revision of Sections 3319 and 1670 of the Civil Code.

The undersigned is the attorney for the Plaintiffs in the class action lawsuit known as Garrett vs. Coast Federal Savings and Loan Association, California Supreme Court Case No. LA 30107.

This action was filed in February of 1971, and it requests that the Defendant refund to all of its clients the exact amount of the late charge which they had paid for the preceeding four years. Coast's note provided that the borrower should pay a sum equal to one-twelfth of 2 percent of the unpaid balance on their loans as a late charge. The lawsuit claims that such a payment is void as a penalty per Civil Code Section 1670. On January 17, 1973, the California Supreme Court, five of six judges signing, granted a hearing in this case. Oral argument was heard on April 9, 1973. It would be presumptuous of me to catagorically state that the Court will rule in my favor. Nevertheless, from the questions asked by the various justices it seems that they will reverse the Appellate Court and send the matter back to the Superior Court to make a determination as to what the actual damages to the Savings and Loan Association will be for processing each late payment. I would like to state in the most definite terms possible that the suggestion put forward by your commission that they be allowed liquidated damages up to 10 percent of the payor's payment is grossly in excess of what actual damages are in fact.

Assume a $200.00 a month mortgage payment. Under the proposals aparently put forward by your commission, the Savings and Loan industry will be at liberty to charge $20.00 as liquidated damages if the payor is anywhere from one to thirty days late on his payment. Such a charge is ridiculous for the following reasons:

Assume an 8 percent loan. If the $200.00 payment is withheld for thirty days and the Savings and Loan Company could have put the $200.00 to work immediately at 8 percent of $200.00 divided by 12, or $1.35. In addition to this, the Savings and Loan Company is specifically damaged to the extent of computer programming time, one IBM card, one envelope, and one eight cent stamp, plus the time involved of a computer programmer to initially program the late payor's payment schedule. At best, these damages to the Savings and Loan Company could not exceed $2.00 to $3.00 per month. Of course, if the loan is an excessively large loan, the lost interest on the payment could be slightly higher. The undersigned has no actual knowledge concerning the cost of the items enumerated above, other than the interest which is easily calculable. However, I have been informed by the manager of a Beneficial Finance Company office that the office is charged the grand and glorious sum of THIRTY EIGHT CENTS ($.38) for the cost of the envelope, the stamp, the computer time, and the IBM card notification. I have also been informed by the attorney for the Federal National Mortgage Company that the costs of processing a late charge are in the vicinity of $4.00 each.

I note by the article in the Daily Journal that correspondence must be addressed to you prior to May 15, 1973. I seriously doubt that the Supreme Court will make a decision in the Garrett case before May 15, but I would suggest to you as strenuously as possible that any recommendations by your commission to the Assembly would be premature if they are made before a decision in the Garrett case is handed down. Such a recommendation would also be premature if you do not make a bona fide effort to determine what actual damages flow from the late payments.

I would also most vigorously suggest to your commission that any recommendations to the Assembly allowing a late payment charge of 10 percent of the payment would be in the nature of a legislative rape of the California homeowner.

Very truly yours,

DAVID G. JACKSON

DGJ/gjw

Memorandum 73-47

EXHIBIT XII

DAVID G. JACKSON
ATTORNEY AT LAW
33 EAST HUNTINGTON DRIVE, SUITE 6
ARCADIA, CALIFORNIA 91006
445-2411

April 23, 1973

California Law Revision Commission
School of Law, Stanford University
Stanford, California 94305

Attention: John D. Miller, Chairman

Dear Mr. Miller:

On April 16, 1973, I addressed a letter to your Commission concerning the proposed revisions relating to liquidated damages. Since that date, I have come into possession of a copy of the tentative recommendations. I have the following observations to make.

First of all, on page 11 thereof under the heading Recommendations it states, "Such a provision would eliminate the uncertainty that now exists. . ." My question is--uncertainty for whom? The answer seems obvious; it must be the Savings and Loan industry.

Secondly, the recommendation of a maximum charge of 10% of the installment payment seems to presuppose that some lenders will charge less than the allowable maximum. This strains my credibility.

Thirdly, nowhere in the 21 page document do I see any reference to Civil Code Section 3302. This Section was enacted in 1872 and has never been altered or amended for 100 years. It sums up very concisely exactly what we are talking about, to wit: "The detriment caused by the pledge of an obligation to pay money only, is determined to be the amount due by the terms of the obligation, with interest thereon."

Fourth, the Commission notes that FHA charges 2% of the payment and the VA charges 4% of the payment. Without any question these two institutions are the largest home loan lenders in the business, and they seem satisfied with a nominal sum. Furthermore, if you would check, you would discover that the major insurance companies in the home loan field restrict their charges to 2% to 4% of the payment.

Fifth, again reference is made to my prior correspondence and to Section 3302 of the Civil Code. The actual loss to the lender by statutory definition cannot exceed the stated interest on the note applied to the monthly payment for the period of time such payment is delinquent. THIS IS A SUM THAT IS EASILY CALCULABLE AT THE INCEPTION OF THE NOTE. Assume an allowance of one month's interest regardless of whether the payment is ten

days late or 30 days late. Such an allowance or late charge would never exceed 2% of the payment--unless an interest rate of 24% per annum were to be charged on the note.

The Commission must take notice of the fact that in today's housing market there is precious little housing available for less than $20,000 and most of the tract developments today price their houses at over $25,000, which means that the buyer's payment on a $20,000 loan for 15 years would be $180 if a 7% rate were charged; for 20 years--$155; for 25 years--$141; and for 30 years--$133. Thus if we disregard completely the increase in these monthly payments by the addition of impound accounts, it can easily be seen that the minimum charge on a 30-year loan would be $13.31 and on a 15-year loan it would be $18.00.

Quite obviously there is no rational relationship between the amount which the Savings and Loan would charge under the proposed revision and what its actual damages would be.

Sixth, there is language in the proposed revision which seems to indicate that the imposition of a 10%-of-the-payment late charge would be beneficial to the payor because it would somehow keep him from getting into deeper trouble in the event the lender began foreclosure proceedings. The obvious fallacy of this argument is that the vast bulk of the people don't have their homes foreclosed upon, that only about one out of six borrowers ever pays a late charge, and that the statistical averages that those who do pay about three a year. (See Answers to Interrogatories, Garrett vs. Coast, L. A. Superior Court Case No. 995634)

In summary it would seem that your proposal would simply codify the practice indulged in by most Savings and Loans already. Your survey indicates that the largest percentage of them charge either 10% of the payment or 1/10 of 1% of the impound balance. In the average case these two figures will be nearly identical and they will exceed the actual damages suffered by the Savings and Loan by a factor of 10. Thus, it would seem to me that this legislation can only foster and perpetuate an existing, vicious practice designed solely for the benefit of the Savings and Loan industry.

Very truly yours,

DAVID G. JACKSON

DGJ/gjw

Memorandum 73-47 EXHIBIT XIII

HARRY B. SEYMOUR
OTTO ROHWER
JOHN F. DOWNEY
ROBERT R. HARLAN
GARTH L. SCALLON
GEORGE BASYE
MALCOLM S. WEINTRAUB
RICHARD G. WORDEN
RICHARD D. WAUGH
JAMES A. WILLETT
RONALD N. PAUL
JOHN J. HAMLYN, JR.
PHILIP A. STOHR
JOSEPH S. GENSHLEA
J. KEITH McKEAG
JAMES I. MICHAELIS
HENRY E. RODEGERDTS
ANTHONY R. GIANNONI
D. STEVEN BLAKE
STEPHEN F. BOUTIN

LAW OFFICES OF
DOWNEY, BRAND, SEYMOUR & ROHWER
1007 SEVENTH STREET
SACRAMENTO, CALIFORNIA 95814
TELEPHONE 441-0131

STEPHEN W. DOWNEY
(1926-1959)
CLYDE H. BRAND
(1926-1964)

April 24, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Liquidated damages

Gentlemen:

Thank you for a copy of your tentative recommendation relating to liquidated damages dated March, 1973. After reviewing your recommendation, I wish to report to you I support your recommendation. I agree with you that contractual stipulation of damages by parties bargaining at arms length should be presumed to be reasonable and enforceable.

I am concerned, however, that in situations where the bargaining parties are not on equal levels of sophistication or economic power, that the liquidated damages provision you are recommending might be used unfairly. Perhaps in such cases standard forms of sales agreements might be required

to contain, in everyday language, what "liquidated damages" means.

Yours truly,

DOWNEY, BRAND, SEYMOUR & ROHWER

By D. Steven Blake
D. Steven Blake

DSB:gh

Memorandum 73-47

EXHIBIT XIV

WALTER L. NOSSAMAN 1886-1964
LAUGHLIN E. WATERS
WILLIAM L. SCOTT
ROBERT B. KRUEGER
RICHARD J. RIORDAN
HAROLD MARSH, JR.
THOMAS L. CAPS
PAUL THOMAS GUINN
WILLIAM E. GUTHNER, JR.
ALVIN S. KAUFER
LACHLAN FOSTER
ALAN J. BARTON
RICHARD R. MAINLAND
BOYD S. LEMON
WILLIAM D. MARKENSON
CARL W. McKENZIE
RINDELL L. MARSH
WILLENE R. NEWMAN
RICHARD Z. TROOP
PETER J. ORTHOFF
JOHN T. PORAY
ROBERT M. TURNER
JAMES A. HAMILTON
ARTHUR R. CHENEN
JOEL M. BERNSTEIN
JEFFREY L. DAROCHER
HOWARD O. COLEMAN
RICHARD D. FYBEL
BRUCE S. ROSS
ROBERT D. MOSHER
FRANK W. MOLLOY
WINFIELD D. WILSON
FREDERIC A. FUDACZ
RICHARD J. MORGAN
MICHAEL I. COWAN
DAVID M. ACHTERKIRCHEN

LAW OFFICES

NOSSAMAN, WATERS, SCOTT, KRUEGER & RIORDAN

THIRTIETH FLOOR • UNION BANK SQUARE
445 SOUTH FIGUEROA STREET • LOS ANGELES, CALIFORNIA 90017
TELEPHONE (213) 628-5221

April 24, 1973

REFER TO FILE NUMBER

Law Revision Commission
School of Law
Stanford University
Palo Alto, California 94302

Re: Code Sections on Damages

Gentlemen:

The Los Angeles Daily Journal of March 21, 1973 indicated that you contemplated various changes in the Civil Code regarding damages. Included in these changes is the provision that monthly payments under $500.00 could be subject to a 10% penalty.

In fact, the typical trust deed lender does not generally incur damages to that extent. While the suggested provision is substantially less than charged by current practice, there is no reason to permit lenders to receive damages greater than that actually suffered. Furthermore, both current law and the suggested new Section 3319 would permit lenders to provide a liquidated damage clause if the stipulated damages were in fact reasonable. If a lender receives interest on his loan as provided in his note, there is no reason why a lender should receive an additional $50.00 when a $500.00 payment is late or $5.00 if a $50.00 payment is late when his actual damages following a late payment (other than interest which is received anyway) are the same irrespective of the amount involved.

In addition, I suggest that any new code provision regarding damages exempt contracts of adhesion from their operation. I also suggest that any changes regarding damages also include the adoption of Uniform Commercial Code Section 2302 (which has not been adopted in California) and make the section applicable to loan contracts. (See West's Commercial Code Section 2302.)

More generally, I suggest that your proposed section will result in great hardship to those with the least bargaining power and that the present sections (Civil Code Sections 1670 and 1671) provide sufficient legislation on the subject. There is no reason, for example, why an earnest money deposit cannot be provided under existing law or why the parties could not contractually limit their liability in any given contract (assuming there is a quid pro quo).

If any change is adopted, I would add the following to proposed Section 3319:

> "A provision in a contract liquidating damages is unreasonable if it provides for an amount of damages significantly in excess of the amount of damages which (a) either could have been foreseen at the time the contract was executed, or (b) were in fact sustained."

I would also eliminate the 10% provision for payments under $500.00.

Thank you for the opportunity to comment.

Very truly yours,

Alvin S. Kaufer
of NOSSAMAN, WATERS,
SCOTT, KRUEGER & RIORDAN

ASK:bh

LAW OFFICES

NOSSAMAN, WATERS, SCOTT, KRUEGER & RIORDAN

THIRTIETH FLOOR • UNION BANK SQUARE
445 SOUTH FIGUEROA STREET • LOS ANGELES, CALIFORNIA 90017
TELEPHONE (213) 628-5221

May 21, 1973

REFER TO FILE NUMBER

State of California
California Law Revision Commission
School of Law
Stanford, California

Attention: John H. DeMoully
Executive Secretary

Gentlemen:

In reviewing proposed Section 2954.6 I have the following comment:

It is not clear that the late payment charge of 10% applies if the payment is eleven days late, one month late, six months late and/or one year late. If the 10% charge is a one time fee, there is no incentive to make the payment (other than foreclosure in the appropriate circumstance) and if it is a monthly charge then it is the equivalent of a penalty of 120% per annum when the actual damages are 7% per annum. In either case if the provision is adopted, it should be clear whether a late payment charge is a one time charge or not.

Following the comments of my prior letter, I still disagree with the legislation except perhaps for proposed Civil Code Section 3019. If that Section is superimposed with current Sections 1670 and 1671, I think the problems the Law Revision Commission finds in the existing state of the law can be resolved.

Very truly yours,

Alvin S. Kaufer
of NOSSAMAN, WATERS,
SCOTT, KRUEGER & RIORDAN

ASK:bh

Memorandum 73-47 EXHIBIT XV

DINKELSPIEL, PELAVIN, STEEFEL & LEVITT
ONE EMBARCADERO CENTER · 27th FLOOR · SAN FRANCISCO 94111 · TELEPHONE (415) 391-3900
CABLE ADDRESS: DINKPELAW

RICHARD C. DINKELSPIEL
ALVIN H. PELAVIN
EDWARD R. STEEFEL
ALVIN T. LEVITT
LENARD G. WEISS
THOMAS B. DONOVAN
ROBERT M. SHEA
PHILIP K. JENSEN
ROBERT M. HARLICK
STEPHEN C. MAYNE
DAVID M. WILSON
JOHN T. WELD
STEPHEN A. COWAN
BARRY REDER
KATE CLAIR FREELAND
CHARLES E. SCHWENCK
RICHARD A. KRAMER

IN REPLY REFER TO:
4640-1248

May 1, 1973

California Law Revision Commission
School of Law
Stanford, California 94305

Re: Liquidated Damages

Gentlemen:

I have reviewed your Tentative Recommendation relating to Liquidated Damages. Generally, I completely support your conclusions and recommendations and believe that, if adopted, they will finally establish some certainty in this very difficult area.

I have some problems, however, with the language of proposed Section 3320. My experience is that, although most home buyers expect a forfeiture of their deposit should they default, this is the "class" of people who most need protection in this area. Most real estate brokers and salespersons are unaware of the meaning or effect of the standard forms (including the C.R.E.A. form described at page 6) so they are unable to explain same to buyers. Most brokers also have favorite "escape" clauses which, they assure buyers, will enable buyer to withdraw from the contract without penalty. Many times such clauses are inartfully worded leading either to an enforceable contract or litigation in which no one wins economically.

Furthermore, many times a default by buyer will cause the seller no loss, e.g., communicated attempt at rescission within one or two days and seller has received no other offers. The basic change in § 3320 would be to change the burden of proof from seller (who now has to prove his "actual damages" under Caplan vs. Schroeder, 56 Cal.2d 515) to buyer whose only claim would be that the provision was "unreasonable under the circumstances existing at the time of the making of the contract".

California Law Revision Commission May 1, 1973

For many home buyers, a 5.00% deposit represents many years of savings and it seems to me improper, in a non-commercial transaction, to provide that there will be such a "forfeiture". Although such a clause would be only optional, you can be sure that all standard forms would have this clause and that few brokers would be able to explain its effect to buyers. And it is buyers, as a class, who need the economic protection rather than sellers.

Therefore, I respectfully suggest that § 3320 apply to transactions involving, for example, more than four units or at the minimum, provide that a liquidated damages clause is unenforceable in a contract for the purchase of a single family residence (as in the standards described in Civil Code § 2949).

Very truly yours,

Philip K. Jensen

PKJ/csh

Memorandum 73-47

EXHIBIT XVI

SIMS AND SOLOMON
ATTORNEYS AT LAW
1206 CHESTER AVENUE
BAKERSFIELD, CALIFORNIA 93301

WILLIAM M. SIMS
GABRIEL W. SOLOMON

TELEPHONE
(805) 327-9781

May 3, 1973

Law Revision Commission
Stanford School of Law
Palo Alto, California 94305

Attn: Mr. John P. Miller, Chairman

Re: Late Payment Penalties

Gentlemen:

I am presently embroiled in litigation with a savings and loan association arising out of their threat of foreclosure absent my payment of a $16.88 penalty on a $330.00 monthly payment on my home as to which I was one day "late" due to having been on vacation and my having forgot to make the payment before leaving on vacation. It is my understanding that you are currently considering proposals for special interest legislation which would legalize the exaction of such arbitrary penalties without regard to any actual cost, expenses or damages which a lender may suffer as a proximate and reasonably foreseeable result of a borrower's failure to make a monthly payment on or before its delinquency date. If this be true let me place of record a vigorous plea that the commission refrain from lending its name and dignity to any such proposal.

I, for one, submit that the Commission cannot help but detract from its stature and weight to the extent that it allows itself to be an advocate of pure "special interest" legislative proposals in behalf of a powerful well heeled industry which is more than capable of looking out for its own interest in the legislative arena. I submit that as a matter of basic Commission policy, the Commission should, absent special and extraordinary consideration, leave the advocacy of special interest litigation to the special interest group who will reap its benefits. Or, to state the same thing differently, I submit that the stature, weight and prestige of the Commission is best preserved and promoted by its functioning as an advocate of legislative proposals for the benefit of the public at large rather than powerful special interest groups which are in no need of a helping hand from your Commission.

Furthermore, to the extent that lenders are allowed to exact more than such actual expenses or damages as is occasioned by a late payment, the lender receives an unjustifiable profit. I ask why in equity and justice should money lenders be given the status of a "special class" exempt from the long standing prohibitions of our law against arbitrary penal exactions such as is reflected in Sections 1670, 1671 and 3302 of our Civil Code.

I submit that prudent self restraint on the part of your Commission would also make it sensible and pragmatic that the Commission at least decline for the time being to act in this late payment penalty sphere since a decision of vital significance in this sphere will any day be forthcoming from the California Supreme Court in the case of Garrett v. Coast Federal Savings and Loan which was argued and submitted for decision by that Court on 4/9/73. At a minimum any legislative proposals relative to so-called late payment penalties should at least await the Supreme Court's decision in the Garrett case and future legislative proposals, if warranted, should be shaped in the light of that imminent decision.

Finally, would you please be kind enough, at my expense, to send me copies of any proposals, studies or reports which the Commission now has on file pertaining to this subject, and also advise me as to the status of the Commission's activities in this matter and its presently anticipated course of action.

I thank you in advance for your courtesy and the Commission's consideration of the views expressed herein.

Yours truly,

SIMS AND SOLOMON

By _____
Gabriel W. Solomon

GWS:cf

cc: Attorney David Jackson
33 East Huntington Drive
Arcadia, California 91066

Assemblyman Ray Gonzales
Senator Mervyn Dymally

Memorandum 73-47

EXHIBIT XVII

RICHARD D. AGAY
ATTORNEY AT LAW
1900 AVENUE OF THE STARS · SUITE 800
LOS ANGELES, CALIFORNIA 90067

CRESTVIEW 7-3595
TREMONT 9-1791

IN REPLY PLEASE REFER TO

May 2, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Tentative Recommendation Relating to Liquidated Damages

Gentlemen:

I was pleased to read the tenor of the above tentative recommendation. I offer the following comments and suggestions.

I refer you to the second paragraph under the comment to the proposed new Section 3319 which includes a listing of relevant considerations. I think that the substance of those considerations is so significant that it must be placed within the code section itself. It is unfair to burden not only the public but attorneys with the necessity of constantly referring to legislative history or comments of draftsmen in order to understand legislation. It is dangerous to rely upon the fact that trial judges will necessarily be familiar with such comments or will interpret legislation according to such comments. It is particularly dangerous to rely upon the use of such comments to aid in interpreting the legislation if the proposed legislation is in any way altered by the legislature prior to its adoption. Such change may or may not have been made with a view to altering the purposes set forth within comments of the drafstman (in this case, the Law Revision Commission) but courts interpreting such change can go either way in such interpretation. If, on the other hand, the comments were codified or at least included within the proposed legislation, then any changes made by the legislature would be clear as to whether such materials were intended to be changed.

Section 2954.5(b) and 3320(b) both make reference to the "requirements of Section 3319". I believe that technically that is a confusing reference because the way Section 3319 has been drafted, there are no "requirements", or at least if there are such requirements, they are requirements for having the section made inapplicable.

To satisfy the problems raised in the second and third paragraphs above, I would propose that Section 3319 be altered in a fashion similar to the following:

> 3319. A provision in a contract liquidating the damages for breach of a contractual obligation is valid if either of the following requirements is met:
>
> a. By other section of this code or any other statute the provision is declared to be valid, reasonable or to satisfy the requirements of

this section.

(b) The provision was not unreasonable under the circumstances existing at the time of the making of the contract.

No provision shall be considered unreasonable unless it is established that at the time of the making of the contract either (1) the maximum amount of all reasonably anticipatable damages including non-recoverable costs or expenses which might reasonably be incurred in order to prove such damages or to prove the right to recover damages, under all possible circumstances was less than the amount liquidated in the contract, or (2) the amount of all reasonably anticipatable damages under all circumstances would be easily and clearly determinable without under any such circumstances the necessity of incurring non-recoverable costs or expenses to prove such damages or the right to recover same.

3319.1. Burdens and Presumptions.

(a) Except as otherwise provided herein there shall be a presumption affecting the burden of proof that a provision in a contract liquidating the damages for breach of a contractual obligation satisfies the requirements of Section 3319.

(b) Upon proof that a provision in the contract liquidating the damages for breach of a contractual obligation has been genuinely negotiated, and is not a part of a form or a copy from a form, the provision shall be considered valid and the requirements of Section 3319 shall be considered to have been met unless the party seeking to invalidate the provision establishes beyond all reasonable doubt that the provision was unreasonable.

(c) There shall be no presumption respecting a provision liquidating the damages for breach of a contractual obligation in a contract which is either a form contract, a contract of adhesion or a contract prepared by party having a greatly superior bargaining position who is unwilling to negotiate the provision, and in each of such instances the party claiming the validity

of the provision shall have the burden of proof that it satisfies the requirement of Section 3319.

I do not purport that the foregoing language represents the last word on this subject or the best possible draftsmanship. I do suggest, however, that if one of the purposes of this legislation is to avoid tying up courts considering damage questions which could be and should be avoided, then the legislation must be sufficiently detailed so that these matters can be quickly and easily disposed of without a court's being required to delve into various matters and then determine the significance of such matters.

The effect of the proposed Section 2954.6(c)(3) is to permit a borrower to have ten days free interest for the scheduled life of a loan. The effect of such a provision on a $100,000 loan would be $2[illegible] during the very first year. This seems to be an unreasonable imposition on a lender. If, as a matter of courtesy, they choose to allow it for occasional violations, that is one thing, but it seems unfair to restrict their right to collect a late payment charge until ten days after the scheduled due date.

Within the same section it would appear more appropriate to permit the lender to apply the payments as he saw fit rather than forcing him for that purpose to apply the payments to the last due payment rather than the first due payment.

I believe that Section 2954.6(d) should have several provisions added to it:

1. First of all, I think that the option should be exercisable only upon notice to the borrower and that such provision should be added.

2. Secondly, insofar as the lender is concerned, it would certainly seem that after 40 days the lender should be entitled to increase the amount of the late payment charge. From a practical standpoint I believe you will find that lenders customarily send out repeated notices and the longer the debt is unpaid the greater the number of notices are sent out and obviously the greater the amount of bookkeeping and stenographic work is entailed. Therefore, providing for additional late payments if certain periods of time elapse would seem only reasonable.

3. Next, I believe that the delinquent installment which becomes a part of the principal should be deemed immediately due and payable such that the adding of the amount to principal is really only for the purpose of computing interest.

Your comment to Section 2954.6(d) came as a surprise to me. I did not read the section to in any way imply that the election to add the late

payment charge to principal foreclosed the lender from treating the failure to pay the late payment charge as a default. I above suggested that the late payment charge be made immediately due and payable which perhaps would resolve the matter. But in this instance it appears we disagree upon what should be the law rather than how to effectuate the purpose. I cannot understand why a lender should be forced to wait for the late payment charge which presumptively, by this section, he is entitled to solely because he further desires to collect interest upon that late payment charge at the same rate as provided in the loan. While I have previously indicated that the comments are not necessarily adhered to by courts in construing legislation, I think it would be ill-advised to conclude that comment whether or not provision was made for the immediately due and payable nature of the late payment charge which is added to principal.

With respect to Section 3320(b), the language "shall be deemed to be reasonable and" seems redundant and the mere qualification "shall satisfy the requirements of Section 3319" seems totally sufficient.

With respect to that same Section 3320, I disagree with the amount you have provided as the liquidated damages. Your own earlier comments within the background portion recognizes that the right to specific performance is an illusory right or one that is not easily exercisable The effect, therefore, of the liquidated damages clause is to give the buyer an option. I suggest that 5% of the purchase price is not a reasonable option price, especially in the sales of lower priced residences. For example, taking a $40,000 house off the market for a month, making plans to move, or, in fact, generating a move, can run up far greater damages than simply $2,000 if the buyer should default. It is well recognized that an empty house will be far less saleable than a full one. The expense of moving back in might be too prohibitive. The seller may be unable to consummate the purchase of another residence, all because of this default. I think that the 5% figure is just too small and that the presumption should start at 10%.

1. Additionally, I feel that the section should be broadened so that the percentages which are deemed reasonable increase as the length of time of the contract of sale (customarily the escrow period) increases. If the property is held off the market 30 or 45 days, then 10% may be sufficient. But, if the property is to be held off the market for 60 to 90 days or even longer, then a higher percentage should be established as being clearly reasonable and therefore satisfying Section 3319.

My brief research does not clearly indicate to me whether attorney fees recoverable under a contract are items of damages or costs. There are strong indications that they must be specifically prayed for and this would tend to indicate that they are considered as elements of damages rather than costs. If I am correct that this is a question that has not been clearly resolved or if resolved, has been resolved in favor of a determination that attorney fees are damages, then an additional subsection

under Section 3319 should be inserted to provide that the liquidated damages do not preclude the additional recovery of attorney fees if provided by law or by contract. Otherwise, if attorney fees are to be considered damages, the liquidated damages clause would be considered to include the attorney fees. That hardly can be the anticipation of the parties, however. Look, for example, to the situation under Section 3320(b) where the contract provides for 5% (or whatever applicable percentage) as a liquidated damages clause. Assume again the sale of a $40,000 residence with $2,000 held in escrow as a deposit. The attorney fees alone, should the buyer refuse to sign escrow instructions permitting the release of those funds to the seller, will come close to or exceed the $2,000 just to get the funds released out of the escrow by way of a lawsuit especially when the costs of the interpleader which the escrow holder will impose are superimposed upon the picture.

I thank you in advance for the privilege of submitting these comments. I have, from time to time in the past, submitted similar such comments but have always been at a loss to follow whether my comments were considered, or if considered and rejected, why rejected. Perhaps the quantity of comments you receive is too vast to supply an individual response to each letter as the comments are considered and turned down for whatever reason.

However, I still am anxious to be kept abreast of this matter and if there is any mechanical way whereby I can at least receive the actions of your commission insofar as they are reduced to writing (memoranda, minutes of meetings or supplemental recommendations) I would be greatly indebted to you if I could be placed upon a mailing list to receive copies of at least those writings which bear upon the comments I have made above.

Thank you again.

Yours very truly,

RICHARD D. AGAY

RDA:LW

Memorandum 73-47

EXHIBIT XVIII

SCHOOL OF LAW
May 8, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Gentlemen:

With regard to your Tentative Recommendations on Liquidated Damages, I have two comments concerning proposed section 3320:

1) What does "contract for the sale of real property" include? Are installment land contracts within the purview of this section? These are described as "real estate sales contracts" in Civil Code section 2985. See California Real Estate Sales Transactions, 11.45-46.

I would prefer to see this liquidated damage provision limited to marketing type deposit receipts, and not made applicable to installment contracts, unless "deposit" is narrowly defined, per my second suggestion.

2) I recommend that you include a definition of "deposit" as used in this section so as to include only the amount of money paid at the time that the offer is made or the contract is signed. In the installment contract area, payments made by the purchaser after execution of the contract but before conveyance of title by the vendor should not be considered part of the deposit. In the deposit receipt sphere, payments that the purchaser is required to make within so many days after acceptance by the vendor, or so many days prior to the close of escrow should not be considered part of the deposit unless the contract expressly declares them to be so.

Sincerely,

Roger H. Bernhardt
Professor of Law

CC: Professor Justin Sweet
RHB:ben

Memorandum 73-47 EXHIBIT XIX

STATE OF CALIFORNIA—BUSINESS AND TRANSPORTATION AGENCY RONALD REAGAN, Governor

DEPARTMENT OF PUBLIC WORKS
LEGAL DIVISION
1120 N STREET, SACRAMENTO 95814

May 9, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Gentlemen:

Re: Tentative Recommendation Relating to Liquidated Damages

We have reviewed the Commission's tentative conclusions on the above noted recommendation and have no objections to the suggested change.

We would like copies of other comments which have been received from other persons and groups.

Very truly yours,

Robert F. Carlson

ROBERT F. CARLSON
Attorney

The Metropolitan Water District of Southern California

Office of General Counsel

May 10, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Tentative Recommendation Relating to Liquidated Damages

Gentlemen:

Comments on the Law Revision Commission's Tentative Recommendations Relating to Liquidated Damages are enclosed. In the event there are questions pertaining to these materials, please feel free to contact the undersigned.

Very truly yours,

John H. Lauten
General Counsel

By Fred Vendig
Fred Vendig
Deputy General Counsel

FV:mj
Enclosure

1111 Sunset Boulevard, Los Angeles, Calif. / Mailing address: Box 54153, Los Angeles, Calif. 90054 / Telephone: (213) 626-4282

May 10, 1973

Subject: California Law Revision Commission's Tentative Recommendation Relating to Liquidated Damages

Proposed Section 3319 of the Civil Code is a considerable advance over previous statutory authority for liquidated damages (Civil Code Section 1671). Nonetheless, it is apparent that the section fails to take due cognizance of the specific problem of liquidated damages in contracts entered into by public agencies for construction of public works or procurement of materials. Liquidated damages are customarily incorporated by public agencies in contracts awarded pursuant to competitive bidding (see, for example: State of California, Department of Public Works, Division of Highways, Standard Specifications, Sections 1-1.26 and 8-1.07 (January, 1973), APWA-AGC Joint Committee, Standard Specification for Public Works Construction Section 6-9 (1970); Metropolitan Water District, General Conditions, Section 29) and may in fact be mandated by law [See, for example, Section 14376 of the Government Code, part of the State Contract Act (Government Code, Section 14250 et seq.); Silva & Hill Construction Co., Inc. v. Employers Mutual Liability Insurance Company, 19 C.A. 3d 914, 918-921, 97 Cal. Rptr. 498 (1971)].

Specifications typically pay due lip service to existing statutory authority and case law when it comes to liquidated damages. However, it is recognized that, as a practical matter, liquidated damages are frequently not used to compensate an owner for late performance as much as they are used to provide a proper incentive

to a contractor to complete the work in timely fashion. This distinction is significant. It stresses the probable deterrent effect of liquidated damages over the probable compensatory effect and recognizes that, notwithstanding development in case law, practice has not comported to legal theory.

A recent appellate decision appears to indicate that courts are unwilling to permit withholding of liquidated damages when they were intended primarily as a deterrent to late completion, in the absence of visible economic damages [Smith, Inc. v. City of Lakeport, 3 Civ. 12877, April 18, 1972 (unreported)]. Yet there is every reason why a public agency, for itself and as a guardian of the public interest, should be able to impose liquidated damages as an appropriate deterrent to late completion and to collect them.

The fact of the matter seems to be that in competitively bid public contracts, liquidated damages are more likely than not pegged to the size of the project according to some arbitrary scale. Accordingly, legislative recognition of the special problem of public construction and procurement contracts might be appropriate. This recognition could take the form of statutory authority for the withholding of liquidated damages in specified minimum amounts scaled to specific sizes of projects which shall be conclusively presumed to be reasonable amounts in view of the difficulty of considering all economic and intangible factors that might damage the public if performance is delayed.

It is conceded that the economic factors could be estimated to a limited extent. A project not completed on time means

a public investment not put to use. Certainly the cost of interest on money invested could be estimated and the amount involved can be substantial. As an example, a $20 million project lying idle due to contractor delay means an average investment of $10 million not put to use. The cost of interest, figured at 6%, would be $600,000 per year or the equivalent of approximately $1660 for each calendar day's delay. A construction project of that size (although the same is true in the case of many procurement contracts) would entail substantial costs for each calendar day's delay for continuing on-site inspection and record keeping, as well as for office contract administration. Finally, it should not be overlooked that major public projects are frequently subdivided into several construction or procurement contracts or both. The consequence of delay of performance of any one of such contracts may be to delay use of the entire project. The potential economic damage accruing to the public agency as a result is vast and could easily exceed the amount of liquidated damages on any of the several contracts which might otherwise be deemed reasonable.

The intangible factors, virtually impossible to translate into dollar amounts, arise from the impact on the public health, welfare and safety from a failure to complete the project on time. For example, a freeway not completed on schedule means that drivers cannot use it for the period of the delay. This delay can mean, inter alia, more accidents on non-freeway roads that must be used by the public in the meantime or cost to the public by having to

use slower routes. As another example, a pipeline intended to transport water which is not completed on time may involve an effect on the public health or welfare in that better water intended for transmission through that pipeline will not be delivered, forcing the public to continue the use of a poorer source of water during the interim.

In the case of any delay in performance of a construction contract, there is a danger to the public safety in that continuing construction exposes the public and workers on the project to construction accidents. In turn, these accidents will be reflected in litigation predicated on the agency's role as owner of the work under contract. Such litigation will have an impact on the public purse, either directly or through increases in insurance premiums. Continuing construction may involve dust, machinery fumes, groundwater seepage problems, noise and other environmental intangibles, all of which cause damage in one form or another, but which cannot adequately be reduced to money figures except in those rare instances when litigation involving questions of eminent domain arise.

In contracts entered into pursuant to competitive bidding, it is the public agency which sets, but does not negotiate, the amount of liquidated damages. It is doubtful that many agencies carefully calculate liquidated damages in accordance with the standards set forth in Section 1671 at the time the contract is drafted. It is equally doubtful that in the future agencies will go to great effort to make liquidated damages "reasonable" so as to survive challenge under the proposed Section 3319. Finally, agencies do not desire to be exposed to litigation regarding the

amount of liquidated damages and the statute could protect them against such needless litigation. These very reasons require a legislative recognition of minimum dollar amounts of liquidated damages that are conclusively presumed to be valid and enforceable. What these amounts should be is a matter that the Commission could determine through further discussion with interested parties.

It may be noted that the approach herein proposed could consistently be combined with a statutory provision similar to that contained in current Senate Bill No. 280 providing the salutary corrolary to liquidated damages, namely a bonus for early completion whenever early completion would be of advantage to the public agency.

Fred Vendig

FV:mj

EXHIBIT XXI

LOYOLA UNIVERSITY SCHOOL OF LAW

1440 WEST NINTH STREET • LOS ANGELES, CALIFORNIA 90015 • PHONE: (213) 776-4870

May 16, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Tentative Recommendations relating to Liquidated Damages

This is in my opinion an excellent piece of work. While there may be problems involved in your proposals relating to late payment charges, I fail to perceive them. I will therefore direct my comments solely to your recommendations and proposed legislation concerning liquidated damages provisions in contracts.

The principles of party autonomy which you advance are sound and should be recognized by appropriate legislation. Some provision should, however, be made for situations where no negotiation preceded the making of the contract. This might perhaps be done by explicitly broadening the requirement of reasonableness under proposed Civil Code Section 3319. It might be stated that a factor to be considered in determining reasonableness is the relationship of the contracting parties at the time of entering into the contract. Another possible approach which, however, poses some difficult drafting problems is to require that the party claiming a right to liquidated damages establish the reasonableness of the contract provisions in situations typically involving adhesion contracts.

The disparate provisions of proposed Civil Code Section 3319 and Commercial Code Section 2718 should be reconciled or there should be a clear statement that Section 3319 does not apply to sales of goods. If it is a valid premise that the reasonableness of a provision for liquidated damages is to be judged in the light of the circumstances confronting the parties at the time of contracting rather than at the time of breach, I see no reason to make an exception in contracts relating to sales of goods. Commercial Code Section 2718 should therefore be amended to conform to Civil Code Section 3319 on this point.

The Commission has undoubtedly considered the problem of specific performance of a contract containing a valid liquidated

damages provision. While the vendor's right to specific performance under a land sales contract is of very little practical importance, as you have clearly noted, the vendee's right to specific performance is often extremely valuable. I think it should be clearly stated in the Code that the use of a liquidated damages provision in a contract otherwise specifically enforceable will not deprive either party to the contract of his equitable remedies thereunder. I am assuming, of course, that a vendee may choose to provide for liquidated damages in the case of a vendor's default, proceeding under Section 3319. In some states this could be interpreted as a waiver of his right to specific performance.

Finally, may I say that I am very glad to have had the opportunity to review the proposed legislation. I had read Professor Sweet's background material when it was first published in the California Law Review and am especially interested in the subject matter of this study because I have long taught the course in Remedies at our Law School. I hope that my comments for what they may be worth do not come too late to be of any possible use. I have had to be out of town, and this coinciding with various family problems has delayed my response.

Yours truly,

Martha S. Robinson

Martha S. Robinson
Professor of Law

MSR/hw

Memorandum 73-47 EXHIBIT XXII

Los Angeles City Unified School District

WILLIAM J. JOHNSTON
Superintendent of Schools

J. GRAHAM SULLIVAN
Deputy Superintendent

Business Division

HOWARD W. JARRETT
Business Manager

ROBERT G. BARNES
Deputy Business Manager

May 16, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Recommendation Relating to Liquidated Damages

Gentlemen:

I recently received your tentative recommendations relating to changes in the law on liquidated damages and I strongly concur with the recommendations.

The Los Angeles Unified School District currently provides for the imposition of liquidated damages in labor and material contracts (construction and maintenance) and in certain contracts for service and equipment. The use of such provisions is predicated upon the diminution of the educational program of pupils resulting from the failure to complete a school facility within prescribed time limits or the failure to provide services or equipment necessary for the educational program. The damage to pupils and the District from such delays is, of course, impossible to estimate and the amount of liquidated damages, which we consider reasonable according to the nature of the various contracts, has encouraged contractors to complete their contracts in a timely manner.

You are probably aware of Senate Bill 280, amended April 26, introduced in this Legislative Session, which would authorize various public entities to provide in contracts both penalty clauses for late completion and bonus clauses for early completion of the contracts. Assembly Bill 502 would require the inclusion of bonus provisions in public contracts which provide for specified damages for late completion. Your recommendation for general provisions on liquidated damages would appear to obviate the need for the foregoing legislation and would eliminate any requirement for bonus clauses.

Liquidated damages clauses included in contracts awarded under competitive bidding presents another problem for public entities because of recent court decisions which have held such contracts to be contracts of adhesion and, thus, not meeting the requirement of agreement of the parties under the current law. It is hoped that your recommendations will eliminate this problem.

I hope that you will call upon us if we may be of any assistance to you in the formulation of your final recommendations as they may apply to public entities, particularly school districts.

Sincerely,

Fred W. Bremenkamp III
Director of Contractual Relations

FWB:nw

Memorandum 73-47

EXHIBIT XXIII

SAN DIEGO GAS & ELECTRIC COMPANY
P.O. BOX 1831, SAN DIEGO, CALIFORNIA 92112

May 14, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Gentlemen:

I have had the opportunity to review the Law Revision Commission's Tentative Recommendation Relating to Liquidated Damages and find the proposed new Section 3319 superseding Civil Code Sections 1670 and 1671 to be very meaningful and beneficial.

It is my understanding that Section 3319 would read as follows:

> "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 unreasonable under the circumstances existing at the time of the making of the contract."

Would you please keep me informed of the status of your recommendations relating to liquidated damages.

Sincerely,

Delroy M. Richardson

Delroy M. Richardson
Attorney

/kb

RESOLUTION PROPOSED BY

ORANGE COUNTY BAR ASSOCIATION

RESOLVED that the Conference of Delegates recommends to the Board of Governors of the State Bar of California that the State Bar support the California Law Revision Commission tentative recommendation relating to liquidated damages.

The basic principles of the tentative recommendation would change the law to provide that liquidated damages provisions in contracts are valid unless unreasonable, and that the reasonableness be judged as of the time of entering into the contract, rather than by hindsight.

OTHER STATUTES AFFECTED

The proposal would amend Civil Code §§ 1951.5 and 3358, repeal Civil Code §§ 1670 and 1671, and add §§§ 2954.6, 3319 and 3320 to the Civil Code.

STATEMENT OF REASONS

The present statutory and decisional law governing liquidated damages provisions restricts their use to situations where the actual damages would be impracticable or extremely difficult to fix, and where a reasonable endeavor has been made to estimate actual damages in arriving at the liquidated provision. Generally speaking, liquidated provisions are difficult to enforce and sometimes misleading to contracting parties.

The California Law Revision Commission in its revised tentative recommendation to the California Legislature, dated March 8, 1973, has provided a convincing and scholarly argument for reform. Basically, the Commission recommends statutory changes to create a somewhat more favorable climate for liquidated damages provisions. Its recommendation is in line with a current trend favoring liquidated damages as represented by Commercial Code § 2718 and other similar statutes.

We feel that the proposed approach would more closely conform to the expectations of contracting parties, tend to improve judicial administration by shortening trial time on many cases, and give contracting parties better control and predictability of risk exposure at the outset of their contractual relationships. The proposed statutes protect against oppressive or coercive use of liquidated damages by permitting the Court to set aside provisions which are adjudged unreasonable when viewed from the time of entering into the contract.

1972 CONFERENCE 12-23

COUNTERARGUMENT PRESENTED BY
SAN DIEGO COUNTY BAR ASSOCIATION TO 1973 CONFERENCE

RESOLUTION NO. 12-23

Re: San Diego County Bar Association Counterargument to Resolution proposed by Orange County Bar Association to Support the California Law Revision Commission Tentative Recommendation Relating to Liquidated Damages (Proposal #12-23)

The San Diego County Bar Association DISAPPROVES this proposed resolution.

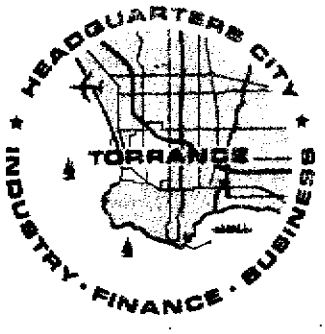
The proposal relates to a "Revised Tentative Recommendation to the California Legislature dated March 3, 1973." We have been advised by the California Law Revision Commission staff that any position would be premature in that the Commission may substantially revise its March 8, 1973 position and might even take a contrary position. The "Tentative Recommendation" of the Commission was distributed by it for comment only.

As the Commission itself has not concluded its research nor established a firm recommendation, it would be premature and unwise for the Conference of Delegates to make a recommendation to the Board of Governors at this time.

Memorandum 73-47

EXHIBIT XXV

STANLEY E. REMELMEYER
CITY ATTORNEY



CITY OF TORRANCE
3031 TORRANCE BOULEVARD, TORRANCE, CALIFORNIA
TELEPHONE (213) 328-5310
90503

May 30, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Gentlemen:

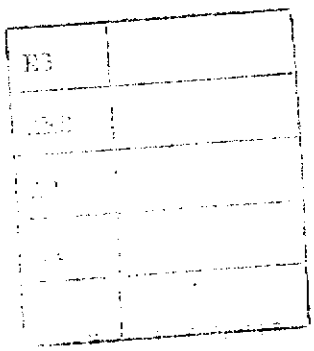
We applaud your efforts to provide for meaningful liquidated damages legislation. We trust that your tentative recommendations will apply to public works contracts as well as other contracts. Because of the difficulty in proving damages in public works contracts, a liberal statute authorizing liquidated damages is a real necessity.

Very truly yours,

Stanley E. Remelmeyer

STANLEY E. REMELMEYER
City Attorney

SER:jc



Memorandum 73-47 EXHIBIT XXVI

UNIVERSITY OF CALIFORNIA, BERKELEY

BERKELEY • DAVIS • IRVINE • LOS ANGELES • RIVERSIDE • SAN DIEGO • SAN FRANCISCO SANTA BARBARA • SANTA CRUZ

SCHOOL OF LAW (BOALT HALL)
BERKELEY, CALIFORNIA 94720
TELEPHONE [415] 642- 1941

June 11, 1973

Mr. John DeMoully
Executive Director
California Law Revision Commission
Stanford University
Stanford, California 94305

Dear Mr. DeMoully:

Thank you for forwarding to me the report which will be submitted to the Commission and some of the comments on it.

I am leaving Berkeley this week so I have not had a chance to study the comments in detail. However, I did read enough of them to get some idea of some of the objections to some of the recommendations and permit me a few comments.

I don't believe I am in much of a position to comment on the wisdom or lack thereof in your proposal regarding late interest charges. However, I think that some of the objections to the statutory formula for earnest money missed the point. The principal objection, other than the amount of the statutory figure, seems to be that real estate purchase agreements are adhesive in nature and that the formula would cause unjust enrichment were the sellers able to retain the property or sell it for at least as much as the defaulting purchaser has promised to pay. Of course, much of the language in a real estate purchase agreement is adhesive. However, the amount of the deposit is very likely to be a negotiated figure. It is true that some buyers may simply go along with what the real estate broker tells them to do. But they generally know what they are doing in this regard and I think that all the evidence indicates that buyers expect to drop the deposit if they don't go through with the deal. So I don't think it is fair to say that buyers will be hoodwinked or oppressed by the adhesive nature of the transaction.

This of course then gets you to the question of unjust enrichment. Some writers have indicated the feeling that it is unfair for the seller to keep the money and still have the property which presumably is worth as much as the purchase price. But they seem to ignore another aspect of unjust enrichment. First, we want rules which will encourage people to perform in accordance with their agreement. Buyers who default generally have no reason for doing so other than a change of mind. If they wished to they could have conditioned their obligation to buy on the occurrence of events which would have given them a defense and as a rule the right to receive their deposit back. What does happen is that the buyer simply has changed his mind. I see no reason why the parties cannot set up a formula for determining how much this change of mind will cost him. Secondly, we also want rules which will operate with the minimum amount of administrative inconvenience in burdening the courts. To the extent that the amount can operate to determine the damages, a good deal of litigation expense to both parties can be avoided. Proving the difference between contract and market price often means a parade of conflicting expert witnesses.

Finally, some of the opponents of a statutory formula seem to have missed the point that the amount set forth for the deposit also limits the obligation of the buyer. They always seem to assume that inflationary costs will always continue and land is always worth at least as much and usually more than the contract price at any given date. If a statutory formula is not used when buyers sue sellers to recover their deposit, sellers often, legitimately and otherwise, contend that they have suffered losses in excess of the deposit. Sometimes they are able to show this, but in any event there is a risk that the buyer will end up losing more than his deposit. And this clearly flies in the face of the intention of the buyer at the time he makes a deposit. From a seller's standpoint as long as he is going to be sued for the deposit he might as well take a shot at showing that actual damages exceeded the deposit.

Some critics have pointed to the not insubstantial amount that can be forfeited by the 5% formula. Determining the formula amount is not an easy matter. On the one hand I can see a sliding scale which will reduce the percentage as the purchase price goes up. The trouble with this is that this puts the highest percentage on the individual purchaser of residential property because these are generally lower in amount. Comments have been made by critics that 5% of $40,000 is $2,000 and this is not a trivial amount. This of course is true. Yet the person who buys the $40,000 house certainly knows what he is doing by way of the deposit. Secondly, he is the one who is in default and as I stated earlier, we still want rules which encourage people to perform in accordance with their contracts.

Perhaps a sliding scale could put a lower amount in a single residence purchaser situation, become greater in small commercial purchases and then diminish in larger commercial purchases. But this is a matter which you are obviously in a better position to determine than I am. My point is that a statutorily fixed earnest money amount makes good sense.

I am going to be out of the country for about six months. One of the things that I will be lecturing on relates to certain types of law reform in this country. Sho tells me that you compiled a bibliography of writings relating to institutions like the Law Revision Commission. If you know of one or two pieces which go into the law reform movement in this country done by groups such as the New York or California Law Revision Commission, it would be helpful to me. These are phenomena which are unusual as far as Europeans are concerned and I think there would be some interest in just how your Commission operates.

Very truly yours,

Justin Sweet
Professor of Law

JS:kh

Memorandum 73-47

EXHIBIT XXVII

Title Insurance and Trust Company

433 SOUTH SPRING STREET · LOS ANGELES, CALIFORNIA 90054 · TELEPHONE (213) 626-2411

HALE WARN
PRESIDENT

ERNEST J. LOEBBECKE
CHAIRMAN OF THE BOARD

July 3, 1973

Mr. William B. Eades, Jr.
Attorney-at-Law
The State Bar of California
601 McAllister Street
San Francisco, California

Re: Liquidated Damages

Dear Mr. Eades:

The fact that the existing law creates uncertainty, and, in fact, invites litigation has already been well established by the Law Revision Commission and Mrs. Levine's report. This need not be further expanded. The revision would change that law so that liquidated damage clauses would be valid unless found to be unreasonable at the time the contract was entered into. The burden of proof would be on the party seeking to invalidate the clause.

Such clauses in real estate leases would be given the same treatment as other such clauses. This seems reasonable even though the Lessee in many (if not most) instances are in a weaker economic position than the Lessor. It would appear that the legislature should establish a guideline to equate with the five percent (5%) of the land sale contract liquidated damage proposal, although this is not to say that the five percent (5%) is the correct sum in those contracts. In real estate leases, a liquidated damage provision of one month's rent for each unexpired year of the term of the lease or leases, the original term of which was not in excess of five years, appears reasonable in approximating the Lessor's actual loss. Leases in excess of five years would have to be (and usually would be) negotiated.

Residential Lessees of the lower economic scale are generally in a weaker bargaining position, but those Lessees that are truly disadvantaged will be unable to make a substantial deposit, and, at the same time, will in all probability be judgment-proof.

Such clauses would be permitted in land sale contracts if the clause itself is separately signed or initialed and provides that the deposit on a portion thereof shall constitute liquidated damages if the buyer defaults. Such damages shall not exceed five percent (5%) of the purchase price unless the parties agree on a larger amount and that larger amount is not unreasonable at the time of the contract.

I believe that the last sentence of Section 3320 should be amended to read: "Nothing in this subdivision precludes the parties from agreeing on a greater amount as liquidated damages if such agreement satisfied the requirements of Section 3319." I can not understand why this provision must be initialed in land sale contracts but not real estate leases, etc. The five percent (5%) figure of Section 3320 (b) seems high. This, while couched in terms of being a maximum, is in reality a minimum. Thus, on the buyer's default on a Twenty-Thousand Dollar ($20,000) house purchase, the liquidated damages would be One Thousand Dollars ($1,000). I feel reasonably sure that all broker-initialed deposit receipts would call for this as the broker usually gets one-half of the forfeiture.

In dealing with late payments on loans secured by a mortgage or a Deed of Trust on real property, the Law Revision Commission proposes to treat late payments when the installment payments are Five Hundred Dollars ($500) or more the same as other liquidated damage clauses. The limits for late payments for installments of less than Five Hundred Dollars ($500) are set forth. This differential is used to help those in a weaker bargaining position and seems proper.

A late charge not paid within forty (40) days may be added to the principal at the option of the lender. He should be required to give the borrower notice of his exercise of this option.

Proposed Section 2954.6 (c) (1) requires the lender to apply an installment payment to the current payment while prior installments are still delinquent. If the loan is in default, must the lender accept such part-payment; and, if he does, has he waived the default so that foreclosure cannot be had on the still delinquent payment. If he can and does refuse to accept the current payment, may he thereafter claim a late charge for that installment.

The proposed legislation does not categorize late charges. If they are additional interest, there will be an usury problem which the legislature cannot solve. If they are to reimburse the lender for his additional costs

in handling late payments, why not allow the borrower to show that such late charges were not reasonable when the loan was made, and why not permit the lender to charge more if he can show such charges are reasonable at the time the loan is made. Possibly, late charges are merely forfeitures sanctioned by the legislature. Whatever they are, the legislation should say so, and the problems raised by such categorization should be met.

While I have pointed out areas where additional work may be necessitated, I strongly feel that this legislation is warranted and is overwhelmingly a positive step forward.

Sincerely,

ROBERT G. ROVE
Associate General Counsel

RGR:vls

cc: Messrs. Pfaelzer, Sears, Green & Hoffman
Mrs. Lavine

STATE OF CALIFORNIA—BUSINESS AND TRANSPORTATION AGENCY RONALD REAGAN, Governor

DEPARTMENT OF TRANSPORTATION
LEGAL DIVISION
1120 N Street
Sacramento, California 95814
P.O. Box 1438
Sacramento, California 95807

July 6, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Gentlemen:

Re: Tentative Recommendation Relating to Liquidated Damages

We have reviewed the comments which have been received by the Commission from other persons and groups on the above-noted tentative recommendation.

The vast majority of the contracts let by the State of California are governed by the State Contract Act (Sections 14250 et seq. of the Government Code). Section 14376 of this Act requires the inclusion of a liquidated damages clause in all contracts subject to the State Contract Act. For this reason, the tentative recommendation will have little effect upon the operations of the State of California, and, therefore, we will make no further comment at this time.

Our present system of operation under Section 14376 of the State Contract Act has been very successful and, as such, we want it to remain unchanged and would oppose any change thereto.

Very truly yours,

ROBERT F. CARLSON
Assistant Chief Counsel

Memorandum 73-78

EXHIBIT XXIX

Civil Code § 2954.5

§ 2954.5 Delinquent payment charge; prerequisites to imposition

(a) Before the first default, delinquency, or late payment charge may be assessed by any lender on a delinquent payment of a loan, other than a loan made pursuant to Section 22466 of the Financial Code, secured by real property, and before the borrower becomes obligated to pay such a charge, the borrower shall either (1) be notified in writing and given at least six days from mailing of such notice in which to cure the delinquency, or (2) be informed, by a billing or notice sent for each payment due on the loan, of the date after which such a charge will be assessed.

The notice provided in either paragraph (1) or (2) shall contain the amount of such charge or the method by which it is calculated.

(b) If a subsequent payment becomes delinquent the borrower shall be notified in writing, before the late charge is to be imposed, that the charge will be imposed if payment is not received, or the borrower shall be notified at lease semiannually of the total amount of late charges imposed during the period covered by the notice.

(c) Notice provided by this section shall be sent to the address specified by the borrower, or, if no address is specified, to the borrower's address as shown in the lender's records.

(d) In case of multiple borrowers obligated on the same loan, a notice mailed to one shall be deemed to comply with the provisions of this section.

(e) The failure of the lender to comply with the requirements of this section does not excuse or defer the borrower's performance of any obligation incurred in the loan transaction, other than his obligation to pay a late payment charge, nor does it impair or defer the right of the lender to enforce any other obligation including the costs and expenses incurred in any enforcement authorized by law.

The provisions of this section shall only affect loans made on and after January 1, 1971.

Memorandum 73-78

EXHIBIT XXX

Government Code Section 53069.85

[Chapter 83]

53069.85. The legislative body of a city, county or district may include or cause to be included in contracts for public projects a provision establishing the time within which the whole or any specified portion of the work contemplated shall be completed. The legislative body may provide that for each day completion is delayed beyond the specified time, the contractor shall forfeit and pay to such agency involved a specified sum of money, to be deducted from any payments due or to become due to the contractor. A contract for such a project may also provide for the payment of extra compensation to the contractor, as a bonus for completion prior to the specified time. Such provisions, if used, shall be included in the specifications upon which bids are received, which specifications shall clearly set forth the provisions.

Government Code Section 14376

§ 14376. Time for completion of work; forfeiture for delay; bonus for completion prior to specified time. Every contract shall contain a provision in regard to the time when the whole or any specified portion of the work contemplated shall be completed, and shall provide that for each day completion is delayed beyond the specified time, the contractor shall forfeit and pay to the State a specified sum of money, to be deducted from any payments due or to become due to the contractor. A contract for a road project may also provide for the payment of extra compensation to the contractor, as a bonus for completion prior to the specified time, such provision, if used, to be included in the specifications and to clearly set forth the basis for such payment.

EXHIBIT XXXI

Assembly Bill 105

SECTION 1. Section 2954.4 is added to the Civil Code, to read:

2954.4. (a) A charge which may be imposed for late payment of an installment due on a loan secured by a mortgage or deed of trust on real property containing only a single-family, owner-occupied dwelling shall not exceed the equivalent of 10 percent of the installment due. No charge may be imposed more than once for the same late payment of an installment. No late charge may be imposed on any installment which is paid or tendered in full when due even though an earlier maturing installment or late charge on an installment may not have been paid in full when due. A payment is not a "late payment" for purposes of this section until at least 10 days following the due date of the installment.

(b) A late payment charge described in subdivision (a) is valid if it satisfies the requirements of this section and Section 2954.5.

(c) This section is not applicable 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, and is not applicable to loans made or negotiated by a real estate broker subject to the provisions of Article 7 (commencing with Section 10240) of Chapter 3 of Part 1 of Division 4 of the Business and Professions Code.

(d) As used in this section, "single-family, owner-occupied dwelling" means a dwelling which will be owned and occupied by a signatory to the mortgage or deed of trust secured by such dwelling within 90 days of the execution of the mortgage or deed of trust.

(e) Subdivision (a) of this section applies only to loans executed after the effective date of this act.

Senate Bill 304

(Cal. Stats. 1973, Ch. 651)(in part)

SEC. 3. Section 10242.5 is added to the Business and Professions Code, to read:

10242.5. (a) A charge which may be imposed for late payment of an installment due on a loan secured by a mortgage or deed of trust on real property shall not exceed the equivalent of 10 percent of the installment due, provided that a minimum charge of five dollars ($5) may be imposed when the late charge permitted by this section would otherwise be less than such minimum charge.

The charge permitted by this section may be assessed only as a percentage of the principal and interest part of any installment due.

(b) No charge may be imposed more than once for the same late payment of an installment. No late charge may be imposed on any installment which is paid or tendered in full within 10 days after its scheduled due date, even though an earlier maturing installment or a late charge on an earlier installment may not have been paid in full. For purposes of this subdivision, a payment or tender of payment made within 10 days of a scheduled installment due date shall be considered to have been made or tendered for payment of such installment.

Memorandum 73-78

EXHIBIT XXXII

[L.A. No. 30107. In Bank. July 18, 1973.]

ROBERTA L. GARRETT et al., Plaintiffs and Appellants, v. COAST AND SOUTHERN FEDERAL SAVINGS AND LOAN ASSOCIATION, Defendant and Respondent.

SUMMARY

In a class action brought by borrowers against a lender, plaintiffs sought to recover sums paid in satisfaction of charges imposed under a loan agreement provision calling for the assessment of a percentage of the unpaid principal balance remaining during the period when any installment payment was in default. Plaintiffs contended that the charges were void under Civ. Code, § 1670, invalidating, with certain exceptions, contracts by which the amount of damage for breach is determined in anticipation thereof. The trial court, however, sustained defendant's general demurrer, without leave to amend, and dismissed. (Superior Court of Los Angeles County, No. 995634, Arthur K. Marshall, Judge.)

The Supreme Court reversed with directions to overrule the demurrer and to allow defendants a reasonable time in which to answer or otherwise plead. Emphasizing that on this particular appeal, it was limited to determining whether the complaint stated a cause of action, the court concluded that the allegations demonstrated a penalty provision, rather than a valid liquidated damages provision. In arriving at this conclusion, the court pointed out that the establishment of the measure of the penalty against the unpaid balance of the loan constituted an attempt to coerce timely payment by a forfeiture not reasonably calculated to merely compensate the lender for damages caused by the delay in payment. Also, the court held that the record clearly showed that the parties had failed to make a reasonable endeavor, such as is a prerequisite to a valid liquidated damages clause, to estimate a fair compensation for loss suffered by the lender as a result of tardiness in payment of an installment. Thus, the court declared that, as outlined by the pleadings, the provision was void, and that the complaint did state a cause of action. (Opinion by Wright, C. J., expressing the unanimous view of the Court.)

[July 1973]

COUNSEL

Jackson & Lober and David G. Jackson for Plaintiffs and Appellants.

Alvin S. Kaufer as Amicus Curiae on behalf of Plaintiffs and Appellants.

Harry Pflaumer and Arthur E. White for Defendant and Respondent.

OPINION

WRIGHT, C. J.—Plaintiffs in a class action appeal from an order of dismissal entered after the court sustained, without leave to amend, defendant's demurrer on the ground that the complaint failed to state a cause of action.

(1) Preliminarily, we observe that we are limited on this appeal to a determination of the sufficiency of the complaint as a matter of law and that for such purpose we treat the demurrer as admitting all allegations of material facts properly pleaded but not admitting contentions, deductions, or conclusions of fact or law. (*Daar* v. *Yellow Cab Co.* (1967) 67 Cal.2d 695, 713 [63 Cal.Rptr. 724, 433 P.2d 732]; 3 Witkin, Cal. Procedure (2d ed. 1971) § 800, p. 2413).

Plaintiffs allege that they are or were obligors under promissory notes secured by deeds of trust in favor of defendant savings and loan association; that each of them has been assessed by reason of his failure to have made timely installment payments, certain sums designated as late charges; and that each such charge is a percentage of the unpaid principal balance of the loan obligation for the period during which payment was in default. Plaintiffs seek to recover sums paid in satisfaction of the charges, contending that they constitute assessments which cannot qualify as liquidated damages and thus are void under Civil Code section 1670.[1] For the reasons

[1]Civil Code section 1670 provides: "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." Section 1671 defines and authorizes a liquidation of damages, stating, "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."

Unless otherwise herein provided all statutory references are to sections of the Civil Code.

hereinafter stated we hold that plaintiffs have stated a cause of action and reverse the order of dismissal.

Plaintiffs' action is brought on behalf of themselves and other similarly situated obligors who within the applicable period of limitations (Code Civ. Proc., § 382) have paid late charges to defendant.[2] They allege that of approximately 32,000 obligors some 5,000 have paid late charges totaling $1,900,000 during the four-year period immediately preceding the filing of the complaint. The promissory note signed by each obligor allegedly includes the following or similar provisions: "The undersigned further agrees that in the event that payments of either principal or interest on this note becomes in default, the holder may, without notice, charge additional interest at the rate of two (2%) per cent per annum on the unpaid principal balance of this note from the date unpaid interest started to accrue until the close of the business day upon which payment curing the default is received."[3]

(2) In order to evaluate the legality of a provision for late charges we must determine its true function and character. If it is as plaintiffs contend a stipulation for ascertaining damages in anticipation of breach its validity must be tested against sections 1670 and 1671. Defendant seeks to avoid the question of damages by maintaining that the lending agreement, to the extent that it requires the payment of additional interest, merely gives a borrower an option of alternative performance of his obligation. If he makes timely payments, interest continues at the contract rate; if, however, the borrower elects not to make such payments, interest charges for the loan are to be increased during the period of optional delinquency. In justification of such a construction of the provision defendant refers us to *Walsh* v. *Glendale Fed. Sav. & Loan Assn.* (1969) 1 Cal.App.3d 578, 585 [81 Cal.Rptr. 804] which relied inter alia on our decisions in *Finger* v. *McCaughey* (1896) 114 Cal. 64, 66 [45 P. 1004] and *Thompson* v. *Gorner* (1894) 104 Cal. 168 [37 P. 900]. (See also *O'Connor* v. *Richmond Sav. & Loan Assn.* (1968) 262 Cal.App.2d 523, 530 [68 Cal.Rptr. 882].)

[2]No issue is presented on this appeal as to the propriety of the class action. A second ground of defendant's demurrer was that the cause was not a proper class action but the court overruled the demurrer as to that ground.

[3]Plaintiffs allege that in practice defendant schedules all payments to be made on the 10th of each month and that if no payment is received by the 19th of the month defendant mails a notice to the late obligor stating the amount of late charge defendant will assess unless the payment has already been mailed. The amount of this charge is calculated to be a sum equal to one-twelfth of 2 percent in some cases and 1½ percent in other cases of the unpaid balance of the loan. Plaintiffs allege that this same charge is made regardless of whether the obligor makes his payment 11 days or 29 days late, or fails to make it at all in that particular month.

The *Thompson* and *Finger* cases essentially involved obligations on promissory notes which included provisions that the loan was to bear one rate of interest if paid at maturity and a higher rate of not paid when the obligation became due. An additional provision in the note in *Thompson*, not relevant to the disposition of the case, related to an increased interest rate if any installment of interest was not paid as it became due.

In *Thompson* we held that a clause in a promissory note providing for a higher rate of interest if the "principal or interest is not paid as it becomes due" is not to be treated as a penalty, but as a contract to pay such higher rate upon and commencing with the happening of one of the contingencies specified in the note, to wit, the failure to make payment of any sum when due.[4]

In *Finger* the promissory note contained a provision that in the event of default at maturity a higher interest rate would apply than if the obligation had been paid when it became due. Unlike *Thompson*, however, the higher rate was to predate the default and relate back to the full term of the note. The court in *Finger* did not distinguish *Thompson* on the differing factual circumstances and rested its holding on *Thompson* in concluding that the amount so assessed was not a penalty within the meaning of section 1670.

Neither *Finger*, and certainly not *Thompson*, stand for the proposition, as defendant would have us hold, that upon a default in the payment of an installment of a note a higher interest rate may be assessed against the *whole of the unpaid balance of the principal* of the note whether or not in default. *Thompson* held only that amounts *in default* may bear a higher interest rate from the date of the default, and *Finger* further held that amounts in default may bear a higher *and retroactive* interest rate. *Thompson* and *Finger* incorrectly have been held to stand for the proposition that "It is the rule in this state that late-charge interest is not in the nature of a penalty, and is valid" in cases where increased interest charges are assessed against the unpaid balance of the principal whether or not in default. (*Walsh* v. *Glendale Fed. Sav. & Loan Assn.*, *supra*, 1 Cal.App.3d 578, 585; *O'Connor* v. *Richmond Sav. & Loan Assn.*, *supra*, 262 Cal.App.2d 523, 530.) Thus defendant's argument that a borrower in default is merely exercising a valid option to elect a different perform-

[4]The term "penalty" has traditionally been utilized to designate, inter alia, a charge which is deemed to be void because it cannot qualify as proper liquidated damages. (See *Better Food Mkts.* v. *Amer. Dist. Teleg. Co.* (1953) 40 Cal.2d 179, 184 [253 P.2d 10, 42 A.L.R.2d 580].) We so utilize the term here; in all instances it denotes a void charge within the meaning of sections 1670 and 1671.

ance under the lending contract does find some support in the foregoing line of cases.

The mere fact that an agreement may be construed, if in fact it can be, to vest in one party an option to perform in a manner which, if it were not so construed, would result in a penalty does not validate the agreement.[5] To so hold would be to condone a result which, although directly prohibited by the Legislature, may nevertheless be indirectly accomplished through the imagination of inventive minds. (3) Accordingly, a borrower on an installment note cannot legally agree to forfeit what is clearly a penalty in exchange for the right to exercise an option to default in making a timely payment of an installment. Otherwise the legislative declarations of sections 1670 and 1671 would be completely frustrated. We have consistently ignored form and sought out the substance of arrangements which purport to legitimate penalties and forfeitures. (See *Caplan* v. *Schroeder* (1961) 56 Cal.2d 515, 519-521 [15 Cal.Rptr. 145, 364 P.2d 321]; *Freedman* v. *The Rector* (1951) 37 Cal.2d 16, 21-23 [230 P.2d 629, 31 A.L.R.2d 1].)

Thompson is not to the contrary. It did not involve a question of penalty. There the full amount of the note was in default and the parties contracted for an increased rate beginning with the moment of default on sums which became payable to the lender. No penalty was assessed as the borrower at the moment of default owed only what he had contracted to pay had there been no default, the principal amount plus accrued interest. If these amounts were not then paid the parties agreed that interest at the higher rate would accrue.

In *Finger*, although it purports to rely on *Thompson*, the question of a penalty was nevertheless involved. Because the increased interest rate was made retroactive the borrower, at the moment of default, became obligated for a sum *in addition* to what he had contracted to pay under the terms of the promissory note had there been no default. The validity of the provision, accordingly, should have been controlled by applicable statutory provisions relating to liquidated damages. We conclude that the *Finger* extension of the *Thompson* holding was unwarranted, and to that extent it is overruled. For similar reasons we disapprove both *Walsh* v. *Glendale Fed. Sav. & Loan Assn.*, *supra*, 1 Cal.App.3d 578 and *O'Con-*

[5]For purposes of our discussion of *Thompson*, *Finger* and related cases we assume that the charges assessed as the result of the borrower's default cannot qualify as liquidated damages (see discussion, *infra*) and address ourselves only to the defendant's contention that such charges should not be deemed to be penalties as they were merely part of a contracted-for alternative performance.

nor v. *Richmond Sav. & Loan Assn., supra,* 262 Cal.App.2d 523 to the extent that they are inconsistent with our views herein.

We recognize, of course, the validity of provisions varying the acceptable performance under a contract upon the happening of a contingency. We cannot, however, so subvert the substance of a contract to form that we lose sight of the bargained-for performance. (4) Thus when it is manifest that a contract expressed to be performed in the alternative is in fact a contract contemplating but a single, definite performance with an additional charge contingent on the breach of that performance, the provision cannot escape examination in light of pertinent rules relative to the liquidation of damages. (*Paolilli* v. *Piscitelli* (1923) 45 R.I. 354, 359 [121 A. 531]; Williston on Contracts (3d ed.) § 781.)[6]

In the instant case, the only reasonable interpretation of the clause providing for imposition of an increased interest rate is that the parties agreed upon the rate which should govern the contract and then, realizing that the borrowers might fail to make timely payment, they further agreed that such borrowers were to pay an additional sum as damages for their breach which sum was determined by applying the increased rate to the entire unpaid principal balance. Inasmuch as this increased interest charge is assessed only upon default, it is invalid unless it meets the requirements of section 1671. (§§ 1670, 1671; see also *In re Tastyeast, Inc.* (3rd Cir. 1942) 126 F.2d 879, 882; *Conn. Mutual Life Ins. Co.* v. *Westerhoff* (1899) 58 Neb. 379, 382 [78 N.W. 724, 79 N.W. 731]; cf. Com. Code, § 2718; *Peary* v. *Aaron Burglar Alarm, Inc.* (1973) 32 Cal.App.3d 553 [108 Cal.Rptr. 242].)

Section 1671 authorizes the assessment of agreed-upon and anticipated damages only when the fixing of the actual damages which would be sustained upon a breach would be "impracticable" or "extremely difficult." Where, as here, the issue is presented on admitted facts it is one of law and must be examined from the position of the parties at the time the contract was entered into. (*Better Food Mkts.* v. *Amer. Dist. Teleg. Co., supra,* 40 Cal.2d 179, 184, 185, 186.) (5) The party seeking to rely on a liquidated damages clause bears the burden of proof. (*Id.*, at p. 185.) Because of the posture of the case before us it is not necessary that we consider issues of "difficulty" or "impracticability."

"The validity of a clause for liquidated damages requires that the parties to the contract 'agree therein upon an amount which shall be presumed

[6]Performance cannot be said to be in the alternative where breach of a former covenant is necessary to give effect to a later covenant. (*Stewart* v. *Bedell* (1875) 79 Pa. 336, 339.)

to be the amount of damages sustained by a breach thereof . . . ." (Civ. Code, § 1671.) This amount must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. (*Dyer Bros. Golden West Iron Works* v. *Central Iron Works, supra*, 182 Cal. 588 [189 P. 445]; *Rice* v. *Schmid, supra*, 18 Cal.2d 382, 386 [115 P.2d 498, 138 A.L.R. 589]; Restatement, Contracts, § 339, p. 554.)" (*Better Food Mkts.* v. *Amer. Dist. Teleg. Co., supra*, 40 Cal.2d 179, 186-187.) It is abundantly apparent for the reasons which follow that the parties here have made no "reasonable endeavor . . . to estimate a fair average compensation for any loss that [might] be sustained" by the delinquency in the payment of an installment. They have, in fact, contracted for the imposition of an additional sum to be paid by the borrower under the guise of an interest charge but which, in the absence of a showing that the same bore a relationship to any loss which may be suffered, must be construed as a penalty.

(6) The fundamental difference between interest and penalty charges is that interest is a measure of compensation to which an obligee is entitled while a penalty is punitive in character. (*U. S.* v. *Childs* (1924) 266 U.S. 304, 305 [69 L.Ed. 299, 45 S.Ct. 110].) A penalty provision operates to compel performance of an act (*Biles* v. *Robey* (1934) 43 Ariz. 276, 286 [30 P.2d 841]) and usually becomes effective only in the event of default (*Lagorio* v. *Yerxa* (1929) 96 Cal.App. 111, 117 [273 P. 856]) upon which a forfeiture is compelled without regard to the actual damages sustained by the party aggrieved by the breach (*Better Foods Mkts.* v. *Amer. Dist. Teleg. Co., supra*, 40 Cal.2d 179). The characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract. (*Dyer Bros. I. Wks.* v. *Central I. Wks.* (1920) 182 Cal. 588, 592-593 [189 P. 445]; *Muldoon* v. *Lynch* (1885) 66 Cal. 536, 539 [6 P. 417].)

(7) Late charges in home loan contracts are presumably imposed because borrowers fail to make timely payments of their obligations.[7] Such charges serve a dual purpose: (1) they compensate the lender for its administrative expenses and the cost of money wrongfully withheld; and (2)

[7]Examination of a booklet issued by defendant to borrowers and which is attached as an exhibit to and incorporated in the complaint aids us in determining whether defendant is alleged to have extracted late charges as a method of procuring prompt payment. Under the section designated "Late Payment" in the booklet defendant explains: "Payments should be mailed early enough to reach us by the due date. The cost of handling delinquent payments, even when we know in advance that they will be late, amounts to more expense than most people imagine. Hence we spread the entire average expense among the customers who are late, these charges are quite high; . . ."

they encourage the borrower to make timely future payments. Whether late charges represent a reasonable endeavor to estimate fair compensation depends upon the motivation and purpose in imposing such charges and their effect. If the sum extracted from the borrower is designed to exceed substantially the damages suffered by the lender, the provision for the additional sum, whatever its label, is an invalid attempt to impose a penalty inasmuch as its primary purpose is to compel prompt payment through the threat of imposition of charges bearing little or no relationship to the amount of the actual loss incurred by the lender. (*First American Title Ins. & Trust Co. v. Cook* (1970) 12 Cal.App.3d 592, 596-597 [90 Cal.Rptr. 645]; *Lagorio v. Yerxa, supra,* 96 Cal.App. 111, 117; cf. *Clermont v. Secured Investment Corp.* (1972) 25 Cal.App.3d 766, 769 [102 Cal.Rptr. 340].)

The contractual provision as alleged in the complaint in the instant case provides that in the event of a late payment a borrower is to be charged an additional amount equal to 2 percent per annum for the period of delinquency assessed against the *unpaid principal balance of the loan obligation.*[8] **(8)** We are compelled to conclude that a charge for the late payment of a loan installment which is measured against the unpaid balance of the loan must be deemed to be punitive in character. It is an attempt to coerce timely payment by a forfeiture which is not reasonably calculated to merely compensate the injured lender.[9] We conclude, accordingly, that because the parties failed to make a reasonable endeavor to estimate a fair compensation for a loss which would be sustained on the default of an installment payment, the provision for late charges is void.

(9) We do not hold herein that merely because the late charge pro-

[8]Such charges are not unusual in the savings and loan industry. A survey of late charges of California state licensed savings and loan associations was conducted by the state Savings and Loan Commissioner in August 1966. That survey indicated that although a majority (113) of the associations charged between 1 percent and 10 percent of the monthly payment for delinquent payments, 21 associations charged 1 percent of the unpaid balance and 11 charged a flat fee, usually $5. (Assem. Interim Com. Rep. Finance and Insurance (1969) Late Payment Fees.)

[9]Late charges are not specifically regulated in this state, and savings and loan associations are exempt from usury proscriptions. (Cal. Const., art. XX, § 22; *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Assn.* (1971) 22 Cal.App.3d 303, 308 [99 Cal.Rptr. 417].) Both the Federal Housing Authority and Veterans Administration, however, regulate late charges for delinquent payments on loans subject to their controls. The FHA limits such charges to 2 percent of each payment more than 15 days late to cover the additional administrative expenses involved. (24 C.F.R. § 241.105.) Similarly the maximum late charge under loans procured through the Veterans Administration is 4 percent of any installment that is delinquent 15 days. (38 C.F.R. § 36.4212.)

vision is void and thus cannot be used in determining the lender's damages, the borrower escapes unscathed. He remains liable for the actual damages resulting from his default. The lender's charges could be fairly measured by the period of time the money was wrongfully withheld plus the administrative costs reasonably related to collecting and accounting for a late payment." (See *Farthing* v. *San Mateo Clinic* (1956) 143 Cal.App.2d 385 [299 P.2d 977].)

Moreover we do not hold that had the amount of the late charges been fixed as a measure of anticipated damages in the event of a default that the provision would necessarily have violated section 1670. As indicated, liquidated damages can be validly anticipated by the parties' reasonable endeavors to do so if "extremely difficult" or "impracticable" to fix. Although we conclude on the record before us that defendant failed in its burden of establishing extreme difficulty in anticipating and fixing damages for the breach of an installment payment,[11] it is possible that on a proper showing defendant might have been able to establish the impracticability of prospectively fixing its actual damages resulting from a default in an installment payment.

The instant case suggests the impracticability under certain circumstances of fixing actual damages when the amount thereof may be small but the cost of ascertaining the same may well be in excess of a reasonable sum agreed to in advance by the parties as fair compensation.[12] We

[10]Defendant argues that the enactment of section 2954.5 impliedly authorized the computation of late charges by the methods currently used by it. This argument is unsupported by a reading of the statute. In section 2954.5 the Legislature dealt primarily with the need and method of notice of the assessment of late charges and the prerequisites mandated before imposition and did not consider the actual computation of such charges.

The Legislature did, however, consider compuation of delinquency charges in the recently enacted Retail Installment Act. Section 1803.6 provides for payment by the buyer of a delinquency charge on each installment in default for a period of not less than 10 days in an amount not in excess of 5 percent of the due installment or $5, whichever is less. The statute also commands that only one such delinquency charge may be collected on any such installment regardless of the period during which it remains in default.

[11]Damages resulting because of the wrongful withholding of money are fixed by law (§ 3302) and the other damages resulting because of a borrower's default on an installment, such as administrative and accounting costs, would not appear to present extreme difficulty in prospective fixing. "Extreme" means "existing in the highest or greatest possible degree . . . going to great or exaggerated lengths . . . going beyond the limits of reason, necessity or propriety . . . ." (Webster's Third New Internat. Dict. (1961) p. 807.)

[12]"Impracticable" means "not wise to put into or keep in practice or effect . . . incapable of being put into use or effect or of being accomplished or done successfully or without extreme trouble, hardship or expense . . . ." (Webster's Third New Internat. Dict. (1961) p. 1136.)

could not hold as violative of section 1671 a provision for liquidated damages where it is established that the measure of actual damages would be a comparatively small amount and that it would be economically impracticable in each instance of a default to require a lender to prove to the satisfaction of the borrower the actual damages by accounting procedures. If the test of impracticability is met the court should give effect to a liquidated damages provision resulting from the reasonable endeavors of the parties to fix a fair compensation.

For the reasons stated the complaint is not vulnerable to defendant's demurrer on the ground asserted. The order of dismissal is reversed and the cause remanded to the trial court with directions to overrule the demurrer and to allow a reasonable time within which to answer or otherwise plead.

McComb, J., Tobriner, J., Mosk, J., Burke, J., Sullivan, J., and Files, J.,* concurred.

*Assigned by the Chairman of the Judicial Council.

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

TENTATIVE

RECOMMENDATION

relating to

LIQUIDATED DAMAGES

March 1973

CALIFORNIA LAW REVISION COMMISSION
School of Law
Stanford University
Stanford, California 94305

Important Note: This tentative recommendation is being distributed so that interested persons will be advised of the Commission's tentative conclusions and can make their views known to the Commission. Comments should be sent to the Commission not later than May 15, 1973.

The Commission often substantially revises tentative recommendations as a result of the comments it receives. Hence this tentative recommendation is not necessarily the recommendation the Commission will submit to the Legislature. Any comments sent to the Commission will be considered when the Commission determines what recommendation, if any, it will make to the California Legislature.

This tentative recommendation includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were enacted since their primary purpose is to explain the law as it would exist (if enacted) to those who will have occasion to use it after it is in effect.

#72 Revised 3/8/73

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 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 the provision must reflect 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 179, 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 liquidated damages provisions.[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 Code[5] encourage the use of such provisions.[6]

A liquidated damages provision may serve useful and legitimate functions.[7] 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

---

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 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). 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.

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.

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.

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, subject to limitations that will prevent the oppressive use of such provisions.

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 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) 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. To permit consideration of the damages actually suffered 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.[8] 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.[9] The Commission recommends that the parties to a contract for the sale of real property be permitted to provide by a clause separately signed or initialed by each party that any part or all of any deposit that is actually made by the purchaser shall constitute liquidated damages to the vendor if the purchaser fails to satisfy his obligation to purchase the property. The Commission further

---

8. See Cal. Stats. 1972, Res. Ch. 22 (directing the Commission to study whether "the law relating to liquidated damages in contracts and, particularly, in leases, should be revised").

9. See background study at 95-100.

recommends that an "earnest money" deposit intended as liquidated damages be deemed to be valid if it does not exceed five percent of the purchase price of the property. This should not, however, preclude the parties from agreeing on a deposit of a larger amount as liquidated damages if such amount satisfies the rules for liquidated damages generally.

The Commission's recommendation would generally conform to existing practice. The Standard Real Estate Purchase Contract and Receipt for Deposit, approved for use in "simple transactions" by the California Real Estate Association and the State Bar of California in form only, contains the following provision:

> 7. If Buyer fails to complete said purchase as herein provided by reason of any default of Buyer, Seller shall be released from his obligation to sell the property to Buyer and may proceed against Buyer upon any claim or remedy which he may have in law or equity; provided, however, that by placing their initials here ($_{\text{Buyer}}$) ($_{\text{Seller}}$), Buyer and Seller agree that it would be impractical or extremely difficult to fix actual damages in case of Buyer's default, that the amount of the deposit is a reasonable estimate of the damages, and that Seller retain the deposit as his sole right to damages.

It should be noted that use of a liquidated damages clause makes retention of the deposit the seller's sole right to damages. Theoretically, the seller still has the alternative remedy of specific performance.[10] But, in most instances, the difficulties in obtaining specific performance make it an unsatisfactory remedy.[11]

---

10. Civil Code § 3389. See also California Real Estate Secured Transactions § 3.21 (Cal. Cont. Ed. Bar 1971).

11. See California Real Estate Sales Transactions §§ 11.62-11.67 (Cal. Cont. Ed. Bar 1967); California Real Estate Secured Transactions §§ 3.21-3.33, 3.52-3.57 (Cal. Cont. Ed. Bar 1971).

Late Payment Charges on Loans Secured by Real Property

Background

The enactment of the general rule recommended by the Commission--that a liquidated damages provision is valid unless 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.[12] 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 Committee[13] 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. 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.

---

12. 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"].

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 decision[14] 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 Insurance[15] 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; neither was enacted. Assembly Bill 105, introduced at the 1973 session, also deals with the same problem.

The validity of many late payment charges imposed on delinquent installments on loans secured by real property is uncertain. 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 [sic] 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 limitation 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.

Recommendations

The Commission has concluded that a statutory provision should be enacted to regulate late payment charges on loans secured by real property.[19] 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 unreasonably high charges.

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

---

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) . . . ."

19. The recommended provision should not apply to a loan made by a credit union, industrial loan company, or personal property broker. Specific statutes now regulate late payment charges on these loans.

the Commission anticipates that many lenders will continue to impose a late payment charge that is less than the maximum permitted.

Installment payment $500 or more. Where the delinquent installment is $500 or more, the validity of a late payment charge should be determined under the general rules relating to liquidated damages. (See discussion on pages 4-5 supra.) Thus, the late payment charge provision will be valid unless the party seeking to invalidate it establishes that it was unreasonable under the circumstances existing at the time of the making of the contract. Use of 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.

Installment payment less than $500. Where an installment payment is less than $500, the need to avoid the expense to the parties of litigating the reasonableness of a late payment charge requires that the imposition of the charge be specifically regulated by statute. Litigation will then be unnecessary if the charge is no greater than the maximum permitted by the statute and otherwise satisfies statutory requirements.[20]

Where the delinquent installment is less than $500, the following regulations should apply:

(1) A late payment charge may be imposed if the borrower fails to pay the full amount of the installment. (For this purpose, "installment" includes principal, interest, and the amount to be allocated to impound accounts.)

(2) No late payment charge should be permitted on an installment which is paid in full within 10 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. Payments should be applied first to

---

20. E.g., Civil Code § 2954.5 (general prerequisites to imposition of a late payment charge on loan secured by real property).

current installments and then to delinquent installments. An installment should be considered paid as of the date it is received by the lender.

(3) The amount of the late payment charge should not exceed 10 percent of the amount of principal and interest included in the delinquent installment. However, where the amount of principal and interest included in the delinquent installment is less than $50, a charge not to exceed five dollars or 20 percent of the principal and interest included in the delinquent installment, whichever is the lesser amount, should be permitted. The borrower is in default if he fails to pay in full the amount required by the contract, which may include amounts to be allocated to impound accounts. Although it is appropriate to impose a late payment charge if the borrower is in default because he has failed to make the full payment required, it would be unfair to include the amount to be allocated to impound accounts in computing the amount of the late payment charge since this amount is in substance a prepayment by the borrower.[21]

(4) The lender should be given the option to add the amount of the late payment charge to the principal if not paid within 40 days from the scheduled due date of the delinquent installment for which the late payment charge was imposed.

PROPOSED LEGISLATION

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

---

21. It should be noted that the lender would be permitted to impose a late payment charge computed on the entire delinquent installment (including amounts to be allocated to impound accounts) if the charge does not exceed the maximum amount computed under the formula proposed above.

An act to amend Sections 1951.5 and 3358 of, to add Sections 2954.6, 3319, and 3320 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:

Civil Code § 1670 (repealed)

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 and 3320.

Civil Code § 1671 (repealed)

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.

Civil Code § 1951.5 (amended)

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.

Civil Code § 2954.6 (new)

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 impound accounts for property taxes, special assessments, and insurance.

(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 10 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 paid as of the date it is received by the lender.

(2) The amount of the late payment charge shall not exceed 10 percent of the amount of principal and interest included in the installment payment except that, where the amount of principal and interest included in the

installment payment is less than fifty dollars ($50), a charge not to exceed five dollars ($5) or 20 percent of the amount of principal and interest included in the installment payment, whichever is the lesser amount, may be made.

(d) If the late payment charge referred to in subdivision (c) is not paid within 40 days from the scheduled due date of the delinquent installment payment for which the charge was imposed, the lender may, at his option, add the late payment charge to the principal.

(e) This section limits only the obligation of a borrower to pay a late payment charge. Nothing in this section excuses or defers the borrower's performance of any other obligation incurred in the loan transaction, 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.

(f) 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. Also, because of the definition of "late payment," the compounding of interest as a sanction for late payment is subject to the limitations imposed by Section 2954.6 as well as any other applicable limitations. See Heald v. Friis-Hansen, 52 Cal.2d 834, 345 P.2d 457 (1959).

As subdivision (e) 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 that must be paid in full to avoid imposition of a 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. Contrast subdivision (c)(2), which limits the amount of the late payment charge to a specified percentage of the principal and interest included in the delinquent installment 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 provision will be valid "unless the party seeking to invalidate the provision establishes that it was 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), supra.

It should be noted that the amount of the late payment charge is a specified percentage of the amount of principal and interest included in the installment payment. Contrast subdivision (e)(2)(defining "installment payment").

Subdivision (d). Subdivision (d) gives the lender the option of continuing to carry the late payment charge as a default or adding the late payment charge to principal after the 40-day period has expired. If the lender elects to add the late payment charge to principal, he cannot thereafter treat the failure to pay the late payment charge as a default. Adding the late payment charge to principal does not, of course, affect the lender's right to treat the failure to pay the delinquent installment payment as a default if it has not been paid.

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

Civil Code § 3319 (new)

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 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 unreasonable, reflects a policy that favors the use of such provisions. See Recommendation and Study Relating to Liquidated Damages, 11 Cal. L. Revision Comm'n Reports 000 (1973), supra.

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 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 could 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 a liquidation of damages provision in a form contract prepared by a party having a greatly superior bargaining position which unreasonably benefits that party 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 permited liquidated damages only where the actual damages "would be impracticable 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--the provision must reflect a "reasonable endeavor" to estimate the probable damages. See Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal.2d 179, 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 the amount selected by the parties reflects a reasonable effort to estimate the probable amount of actual damages. 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. 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. For late payment charge provisions, see, e.g., Civil Code §§ 1803.6 (retail installment sales), 2954.6 (real estate loans), 2982 (automobile sales finance act); Fin. Code §§ 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 3320, 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.

Civil Code § 3320 (new)

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

3320. (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 satisfy his obligation to purchase the property. 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 shall satisfy the requirements of Section 3319 if it does not exceed five 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 3320 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 if the clause is separately signed or initialed and the amount of the deposit is reasonable. 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). As to the effect of a liquidated damages provision on the right to specific performance, see Recommendation and Study Relating to Liquidated Damages, 11 Cal. L. Revision Comm'n Reports 000 (1973), supra at 6.

Subdivision (b) is included to avoid disputes as to the reasonableness of the amount specified to be liquidated damages if it does not exceed the five-percent limitation. The subdivision does not preclude the parties from providing that a larger amount constitutes liquidated damages if the subdivision (a) requirement of a separately signed or initialled clause is satisfied and the requirements of Section 3319 are satisfied.

Section 3320 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.

Civil Code § 3358 (amended)

Sec. 7. Section 3358 of the Civil Code is amended to read:

3358. ~~Notwithstanding the provisions of this Chapter, no person can~~ Nothing in this chapter authorizes a person to 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, 3339, and 3340.

Operative Effect

Sec. 8. This act applies only to contracts executed after January 1, 1975.

Comment. The delay in the operative effect of the act will permit time for revisions of forms, standard agreements, and the like.