

#72

11/15/73

Memorandum 73-97

Subject: Study 72 - Liquidated Damages

The Recommendation Relating to Liquidated Damages has been revised in accordance with the Commission's decisions at the October meeting. We hope this recommendation may be approved for printing at the November-December meeting. Two copies of the recommendation are attached to this memorandum; make your suggested editorial changes on one copy and return it to the staff at the meeting.

Respectfully submitted,

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Legal Counsel

STATE OF CALIFORNIA

**CALIFORNIA LAW  
REVISION COMMISSION**

**RECOMMENDATION**

*relating to*

**LIQUIDATED DAMAGES**

**November 1973**

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

## RECOMMENDATION OF THE CALIFORNIA

## LAW REVISION COMMISSION

relating to

## LIQUIDATED DAMAGES

## INTRODUCTION

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.<sup>1</sup> The general statutory provisions governing such a liquidated damages provision are Sections 1670 and 1671 of the Civil Code.<sup>2</sup> 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.<sup>3</sup> The judicial decisions

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1. For a discussion of the varying forms a liquidated damages clause may take, see background study, Sweet, Liquidated Damages in California, at pp. \_\_\_\_\_ infra, reprinted from 60 Cal. L. Rev. 84 (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. *McCarthy v. Tally*, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956); *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal.2d 179, 187, 253 P.2d 10, 15 (1953). See also *Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n*, 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973); *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.<sup>4</sup> 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<sup>5</sup> encourage the use of such provisions.<sup>6</sup>

A liquidated damages provision may serve useful and legitimate functions.<sup>7</sup> 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

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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 Corp. Code § 13353; Food & Agri. Code § 54264. 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 Govt. Code § 54348 (services of local agency enterprise); 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 Govt. Code §§ 14376, 53069.85; Sts. & Hwys. Code §§ 5254.5, 10503.1.

7. The following discussion draws heavily upon the background study. See background study at pp. \_\_\_\_\_ infra.

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 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.<sup>8</sup> 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.<sup>9</sup> 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.<sup>10</sup> The Commission further

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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 pp. \_\_\_\_\_ infra.

10. The special provision for liquidated damages in land sale contracts should not, however, apply to installment land contracts.

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 (Buyer) (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,<sup>11</sup> but in most instances the difficulties in obtaining specific performance make it an unsatisfactory and unused remedy.<sup>12</sup>

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

12. 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

Proposal of a general rule that a liquidated damages provision is valid unless shown to be unreasonable requires examination of the amount of late payment charges which may be assessed in connection with a loan secured by real property.<sup>13</sup> Until recently, the amount of the late payment charge on a loan secured by real property was not significantly regulated by state statute.<sup>14</sup> However, in response to well-documented abuses and overreaching by lenders in this area,<sup>15</sup> legislation was introduced at the 1973 session of the Legislature to regulate late payment charges. The Legislature enacted Business and Professions Code Section 10242.5<sup>16</sup> which allows mortgage loan brokers to impose a charge for late payment of an installment due on a loan secured by a mortgage or deed of trust on real property equal to no more than 10 percent of the principal and interest portions of the installment due or five dollars, whichever is greater. Assembly Bill 105, also introduced at the 1973 session, would similarly regulate late payment charges on all loans secured by a mortgage or deed of trust on single family, owner-occupied dwellings.<sup>17</sup>

13. Late payment charges provisions have been held to be liquidated damages provisions. See *Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n*, 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973); *Clermont v. Secured Investment Corp.*, 25 Cal. App. 3d 766, 102 Cal. Rptr. 340 (1972).
14. Late payment charges are regulated by provisions applicable to credit unions (Fin. Code § 14852), to certain industrial loan companies (Fin. Code §§ 18667, 18934), and to certain personal property brokers (Fin. Code § 22480).
15. See Assembly Interim Committee on Finance and Insurance, Late Payment Fees 6-9 (mimeographed, May 20, 1970).
16. Cal. Stats. 1973, Ch. 641, § 3, effective January 1, 1974.
17. At the time of this writing, A.B. 105 is in conference committee. A.B. 105 would not be applicable to credit unions, industrial loan companies, personal property brokers, or real estate brokers.

In the absence of such statutory regulation, the validity of many late payment charges imposed on delinquent installments on loans secured by real property is uncertain. In Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n,<sup>18</sup> the California Supreme Court held that:<sup>19</sup>

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. 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.

The court held open the possibility that a lender could show the "impracticability of prospectively fixing its actual damages"; in such a case, a liquidated damage provision "resulting from the reasonable endeavors of the parties to fix a fair compensation" would be upheld.<sup>20</sup>

In light of the incomplete legislation governing late payment charges on loans secured by real property and the uncertainty concerning the validity of such charges under judicial tests, the Commission recommends that a more comprehensive regulatory scheme be enacted.

#### Policy Factors

The regulation of late payment charges on loans secured by real property is a matter involving conflicting policy considerations. An Assembly Committee report states:<sup>21</sup>

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18. 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).
  19. 9 Cal.3d at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851. The charge involved in Garrett was two percent per annum for the period of delinquency assessed against the unpaid principal balance of the loan obligation.
  20. 9 Cal.3d at 741-742, 511 P.2d at 1204, 108 Cal. Rptr. at 852.
  21. Assembly Interim Committee on Finance and Insurance, Late Payment Fees 11-13 (mimeographed, May 20, 1970).

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 also noted the FHA charge of two percent and the VA charge of four percent of the delinquent installment. 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 higher than the cost of a reasonable late payment charge.<sup>22</sup> 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.

### Conclusions

The Commission has concluded that a statutory provision should be enacted to regulate late payment charges on loans secured by real property.<sup>23</sup> 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

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22. 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) . . . ."
23. 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 most of these loans. See Fin. Code §§ 14852 (credit unions, 18667(a)(5) and 18934 (industrial loan companies, 22480 (personal property brokers). But see Fin. Code §§ 18649 and 18669.2 (exceptions to § 18677), 22053 (exception to § 22480).

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.<sup>24</sup>

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.<sup>25</sup>

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

24. See discussion at pp. 4-5 infra.

25. 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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup>

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

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26. The 10 percent limit is in accord with new provision regulating mortgage loan brokers. Bus. & Prof. Code § 10242.5 (Cal. Stats. 1973, Ch. 641, § 3, effective January 1, 1973). This provision would be superseded by the recommended provision.
27. Business and Professions Code Section 10242.5 in effect allows a flat \$5 where the principal and interest portion of the installment is less than \$50 regardless of how small the payment is. The Commission's proposal would be fairer to borrowers since, where the principal and interest portion is under \$25, a maximum charge of 20 percent (less than \$5) is allowed.
28. 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.

PROPOSED LEGISLATION

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

An act to repeal Section 10242.5 of the Business and Professions Code, and 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:

Business & Professions Code § 10242.5 (repealed)

Section 1. Section 10242.5 of the Business and Professions Code is repealed.

~~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.~~

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Comment. Section 10242.5 is superseded by Civil Code Section 2954.6.

Civil Code § 1670 (repealed)

Sec. 2. 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. 3. 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. 4. 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. 5. 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 tendered or 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, an installment payment shall be considered paid as of the date it is received by the lender and, unless the borrower otherwise directs at the time the installment is paid, payments shall be applied first to current installment payments and then to delinquent installment payments.

(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

§ 2954.6

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 and thereafter charge interest on it at the contract rate. 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.

(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 and, therefore, is a statutory exception to Section 3302. 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 Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973); 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) and O'Connor v. Richmond Sav. & Loan Ass'n, 262 Cal. App.2d 523, 68 Cal. Rptr. 882 (1968) (disapproved in Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, supra). 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). Section 2954.5 provides that, before a late payment charge may be assessed, the lender shall give the borrower either written notice of the delinquency and six days from mailing within which to cure it or a notice sent when each payment is due which indicates the date after which the charge will be assessed. Assuming that these 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).

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 (a)(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. 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). See also Section 3319 and Comment.

Civil Code § 3319 (new)

Sec. 6. Section 3319 is added to the Civil Code, to read:

3319. (a) 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.

(b) Subdivision (a) does not apply to provisions included in public contracts pursuant to Section 14376 or 53069.85 of the Government Code, or where a statute governs the validity of a provision for liquidated damages in a certain type of 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).

Subdivision (a) of 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 permitted 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 McCarthy v. Tally, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956); Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal.2d 179, 187, 253 P.2d 10, 15 (1953).

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).

Subdivision (b) makes clear that subdivision (a) does not 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); Govt. Code § 54348 (services of local agency enterprise). These other statutes--not Section 3319--govern the situations to which they apply. Of course, where there are exceptions to the coverage of some provision governing liquidated damages in certain types of contracts, Section 3319 does apply. E.g., Fin. Code §§ 18649 and 18669.2 (exceptions to § 18667), 22053 (exception to § 22480). 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. Government Code Sections 14376 (requiring state public works contract to contain a charge for late completion) and 53069.85 (allowing cities, counties, and districts to include charge for late completion in contract) remain unaffected by subdivision (a).

#### Civil Code § 3320 (new)

Sec. 7. 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).

(c) This section does not apply to real property sales contracts as defined in Section 2985.

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).

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 initialed clause is satisfied and the requirements of Section 3319 are satisfied.

Subdivision (c) makes clear that liquidated damages provisions in real property sales contracts (commonly called installment land contracts) as defined in Section 2985 are not governed by Section 3320.

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. 8. 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. 9. 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.