

Memorandum 75-4

Subject: Study 72 - Liquidated Damages

Attached to this memorandum is a staff draft of the Recommendation Relating to Liquidated Damages incorporating the decisions made at the November meeting. Attached as Exhibit I is a letter from Richard Agay commenting on the materials on liquidated damages considered at the last meeting. Basically, Mr. Agay would seem to agree with the decisions made at the November meeting with the probable exception that he would prefer retaining the earnest money deposit provision and providing a higher level of automatically valid liquidated damages in real property sales contracts.

The recommendation as redrafted retains the approach of the first recommendation; the need for upholding liquidated damages provisions unless they are shown to be unreasonable in light of the circumstances existing at the time of contracting is emphasized. The new material concerning adhesion and consumer contracts is treated as an exception to this general approach.

The staff was directed to determine whether subdivision (e) of Section 3320 in the original recommendation (providing an exception to the earnest money provisions in the case of installment land contracts) should be retained. The staff has concluded that, since the reason for the exception was to prevent payments under such contracts from being automatically valid liquidated damages under the provisions of subdivisions (b) and (c), the substance of subdivision (e) is no longer needed. Under both the original and redrafted recommendation, liquidated damages in installment

land contracts would be left to other provisions. The only remaining question is whether Section 3320 in the redrafted recommendation (requiring liquidated damages provisions in contracts for the sale of real property to be separately signed or initialed by both parties) does or should apply to installment land contracts. The staff can see no reason why this requirement should not be applied to such contracts since its purpose is to give the parties notice of the clause; hence, the exception should not be retained.

Respectfully submitted,

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IN REPLY PLEASE REFER TO:

RDA - Legislation

November 20, 1974

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

Attention: Mr. John H. DeMouilly
Executive Secretary

Re: Liquidated Damages

Dear Mr. DeMouilly:

I have read the October 28, 1974 Memorandum 74-63 and the supplement thereto. I have further read the November 8, 1974 letter from Ronald P. Denitz.

In amplification of the statements made in my May 2, 1973 letter (Exhibit XVII to the June 25, 1973 Memorandum 73-47) and my May 2, 1974 letter, I offer the following additional comments:

A. Mr. Denitz' point number one obviously is in total accord with the views I have previously expressed. Notwithstanding the cries of potential injustice by reason of form contracts, I do not believe that any of the 25+ letters as exhibits to the June, 1973 Memorandum strenuously assert that Sections 1670 and 1671 now make available a meaningful remedy to the seller of real estate and especially to the seller of residential real estate.

B. Similarly, with respect to item 5 of Mr. Denitz' letter, I again agree, and in this instance I suggest the only means of resolving the question of percentages is for the commission itself to take an honest look at whether any member thereof would satisfy himself with the receipt of merely five percent of the sale price of residential real estate in exchange for the default by the buyer. I again note, that especially in the area of low priced sales of real estate, the seller is economically unable to employ the necessary experts to show the drop in valuation and the personal inconvenience involved in residential sales is as difficult to determine as damages in a personal injury action but unfortunately, not allowable to the same extent as in a personal injury action.

C. Likewise, I agree with the position taken in Mr. Denitz' point number three. To shift the burden of proving the reasonableness of the provision makes the legislation totally meaningless, since that is the position which we are presently in.

D. Likewise, I agree with the suggestion that the provisions, with respect to the late payment charges, be eliminated so as to eliminate much of the thrust of the opposition to the proposed legislation. The problem of late payment charge is totally different from the general area of contractual provisions for liquidated damages and especially different from the problem of the seller of real estate.

Perhaps there is an area for abuse which would be created by legislation similar to that initially proposed for the liquidated damages and the presumption of validity in real estate sales contracts. But that potential must, it seems, be measured against the actual existing abuse which permits virtually every buyer to default on his contract and nonetheless obtain full refund of his money without the seller's having any meaningful recourse. Only those sellers so wealthy that they can afford to engage in the type of litigation necessary to prove damages under existing laws can avoid the losses from such defaults. The failure to change the law, therefore, socially results in a continued detriment to the vast middle class and even lower middle class who are in the position of selling real estate or entering into contracts, with the vast majority of those benefiting from the existing law being those who intentionally breach their obligations or those who are so wealthy that they can afford the litigation under existing laws.

In examining the cries of anguish from consumer groups and from the poverty law clinics, it seems essential to simultaneously consider the foregoing.

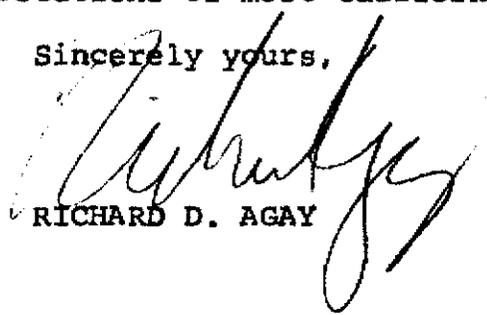
For myself, my advice to any seller of real estate is that his contract of sale, no matter what teeth are inserted into it, amounts to nothing more than an option for the buyer to tie up his property. He certainly shouldn't assume that any detriment incurred by relying upon the completion of that contract will ever be recovered from the buyer should the buyer default.

Finally, let me just again note that creation of a law which makes the deposit (be it made or only promised to be made) the measure of damages would bring the law of the State of California to the place where most persons, other than lawyers, assume it to be and that is that in the event of a default in the purchase

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of real estate, the buyer forfeits his deposit and can walk away without further responsibility. Within the reasonable restraints proposed for the liquidated damages legislation, I cannot see why the commission or the legislature would not want to recognize and legalize the expectations of most Californians.

Sincerely yours,



RICHARD D. AGAY

RDA:jm

RECOMMENDATION INTRODUCTION

Existing California law permits the parties to a contract, in some circumstances, to agree on the amount or the manner of computation of damages recoverable for breach.¹ Two requirements must be satisfied. Sections 1670 and 1671 of the Civil Code² permit the enforcement 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 interpreting and applying these requirements, however, 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 Code⁵ encourage the use of such provisions.⁶

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 (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 & S. 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).

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 & AGRIC. 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).

reprinted in
11 CAL. L.
REVISION COMM'N
REPORTS at
1229 (1973)

BUS. & PROF.
CODE § 10242.5
(certain real
estate loans),

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 not give sufficient consideration to legitimate excuses for nonperformance, that the court may be unduly sympathetic to the claim of the opposing party that all his losses should be paid by the breaching party, or that the court may manifest prejudice against contract breach to the extent of assessing damages on a punitive basis.

A nonbreaching party may use a liquidated damages provision because on occasion a breach will cause damage, but the amount of the damage cannot be proved under damage rules normally used in a judicial proceeding. 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 liquidated damages 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 will 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,

⁷ For provisions authorizing liquidated damages in certain public construction contracts, see GOVT CODE §§ 14376, 53069.85; STS. & HWYS. CODE §§ 5254.5, 10503.1.
⁸ The following discussion draws heavily upon the background study.

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. *This is frequently the case where consumers are involved.*

The Commission believes that the use of liquidated damages provisions is beneficial and should be encouraged, subject to limitations to protect against the oppressive use of such provisions, *especially in consumer cases and where the parties have substantially unequal bargaining power.*

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 but would still enable courts to invalidate such provisions in situations where they are 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 of the amount of actual damages.

(3) A 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 a liquidated damages

Except as noted in the next paragraph the

provision, which is to simplify any litigation that may arise out of a breach of the contract.

(4) In cases where the party seeking to invalidate the liquidated damages provision shows that the contract is a consumer contract (made for personal, family, or household purposes) or was made when he was in a substantially inferior bargaining position, the party seeking to enforce the provision should bear the burden of proving reasonableness. This would protect the weaker and less experienced parties.

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 applicable 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 Purchase Contracts

The parties to a contract ~~for the sale of~~ real property may desire to include in the contract a provision liquidating the damages if the purchaser fails to complete the purchase. In some cases, the parties may agree that an "earnest money" deposit constitutes liquidated damages if the purchaser fails to complete the sale. The validity of such provisions under existing law is uncertain.⁹

for the sale of

The Commission recommends the adoption of a provision recognizing liquidated damages clauses in contracts for the sale of real property. A liquidated damages provision in such contracts, enforceable by either the buyer or the seller, should be valid only if the provision satisfies the general requirements for validity of a liquidated damages provision outlined above and is separately signed or initialed by each party to the contract. This requirement will alert the

⁸ See Cal. Stats. 1972, Res. Ch. 22 at 3223 (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, 11 CAL. L. REVISION Comm'n REPORTS 1229, 1242-1247 (1993).

parties to the fact that the liquidated damages clause is included in the contract.¹⁰

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

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.

PROPOSED LEGISLATION

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

An act to amend Sections 1951.5 and 3358 of, to add Sections 3319 and 3320 to, and to repeal Sections 1670 and 1671 of, the Civil Code, and to amend Sections 14376 and 53069.85 of the Government Code, relating to liquidated 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.

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. Sections 1670 and 1671 are superseded by Section 3319.

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 § 3319 (added)

Sec. 4. Section 3319 is added to the Civil Code, to read:

3319. (a) Except as otherwise provided by statute, a provision in a contract liquidating the damages for breach of the contract is valid unless the party seeking to invalidate the provision establishes that it was unreasonable under the circumstances existing at the time the contract was made.

(b) Where the party seeking to invalidate the provision establishes that he was in a substantially inferior bargaining position at the time the contract was made or that the contract is primarily for his personal, family, or household purposes, the provision is invalid unless the party seeking to enforce the provision establishes that it was reasonable under the circumstances existing at the time the contract was made.

Comment. Section 3319 provides that a liquidated damages provision in a contract is valid if it is reasonable and places the burden of proof generally on the person seeking to invalidate the provision. It thus reflects a policy that favors the use of liquidated damages provisions, reversing the restrictive policy of former Sections 1670 and 1671. However, in consumer cases and in cases where the parties are in unequal bargaining positions, Section 3319 shifts the burden of proof to the party seeking to enforce the liquidated damages provision.

Section 3319 limits the circumstances that may be taken into account in the determination of reasonableness to those in existence "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 COM. CODE § 2718.

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~~former~~ Section 1672 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. Tully*, 46 Cal.2d 577, 584, 297 P.2d 931, 986 (1956); *Betier Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal.2d 179, 187, 253 P.2d 10, 15 (1953).

former

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 [REDACTED] 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. **Other 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, [REDACTED]

[REDACTED] and whether the liquidated damages provision is included in a form contract. **In** this connection, it should be noted also that nothing in Section 3319 affects the power of a court to modify or nullify terms in a contract of adhesion. See discussion in 1 B. WITKIN, SUMMARY OF CALIFORNIA LAW *Contracts* § 13 at 35-36 (8th ed. 1973).

Subdivision (a) implements the policy favoring liquidated damages provisions by placing on the party seeking to avoid the provision the burden of proving that the provision was unreasonable when the contract was made. However, where the party seeking to avoid the provision makes an initial showing that he was in a substantially inferior bargaining position or that the contract is "primarily for his personal, family, or household purposes," subdivision (b) makes clear that the burden of proof shifts to the party seeking to enforce the liquidated damages provision. The "primarily for his personal, family, or household purposes" standard is taken from the Unruh Act

which governs retail installment sales. See Civil Code § 1802.1. It should be noted that, where the party seeking to avoid the provision is the non-consumer party to a consumer contract or is the superior party in the case of disparate bargaining positions, he may not take advantage of the burden-shifting provision.

The introductory clause of subdivision (a) makes clear that the *section* 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), [REDACTED] 2982 (automobile sales finance); FIN. CODE §§ 14852 (credit unions), 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 Section 18667), 22053 (exception to Section 22480).

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 a charge for late completion) [REDACTED] remain unaffected by Section 3319.

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. [REDACTED]

[REDACTED] 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 CIVIL CODE § 1950.5 (payment or deposit to secure performance of rental agreement). Compare CIVIL CODE § 1951.5 (liquidation of damages authorized in real property lease). Section 3319 also controls the determination of the validity of a liquidated damages provision in a contract for the sale of real property. Liquidated damages provisions in such contracts may be enforced by either the buyer or the seller. See also Section 3320 (requiring such provisions to be signed or initialed by both parties).

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Code § 10242.5
(certain real
estate loans),

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Civil Code § 3320 (added)

Sec. 5. Section 3320 is added to the Civil Code, to read:

3320. A provision in a contract for the sale of real property liquidating the damages where a party fails to satisfy his obligation to purchase or sell the property is valid only if the provision is separately signed or initialed by each party and is valid under Section 3319.

Comment. Section 3320 is new. It recognizes that the parties to a contract to sell real property may provide for liquidated damages for either party's failure to satisfy his obligation. Under former law, the validity of such provisions was uncertain. See California Law Revision Commission, Recommendation Relating to Liquidated Damages (January 1975). Where a liquidated damages provision in a contract for the sale of real property is separately signed or initialed as required by Section 3320 and satisfies the requirements of Section 3319, the limitations of Sections 3306 and 3307 do not apply.

Civil Code § 3358 (amended)

Sec. 6. Section 3358 of the Civil Code is amended to read:

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

Comment. Section 3358 is amended to replace the former listing of specific provisions with a general reference to statutes that constitute an exception to the rule stated. The former listing of specific provisions was incomplete.

Government Code § 14376 (amended)

Sec. 7. Section 14376 of the Government Code is amended to read:

14376. 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. *Section 3319 of the Civil Code does not apply to contract provisions under this section.*

Comment. The last sentence is added to Section 14376 to make clear that the enactment of Civil Code Section 3319 has no effect on contract provisions under Section 14376.

Government Code § 53069.85 (amended)

Sec. 8. Section 53069.85 of the Government Code is amended to read:

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. *Section 3319 of the Civil Code does not apply to contract provisions under this section.*

Comment. The last sentence is added to Section 53069.85 to make clear that the enactment of Civil Code Section 3319 has no effect on contract provisions under Section 53069.85.