

Memorandum 75-77

Subject: Study 72 - Liquidated Damages

Attached is a staff draft of a Recommendation Relating to Liquidated Damages. We have completely revised the prior draft. We believe that the attached draft accurately reflects the Commission decisions made at the last meeting, but we note some matters below for your special attention:

(1) We have created a new title to include the liquidated damages provisions. It does not seem appropriate to include them in Title 4 on "unlawful contracts." An outline of Title 4 (as revised) and new Title 4.5 is included at the end of the preliminary portion of the recommendation.

(2) We have amended Section 1671 of the Civil Code to conform to the language used in our other provisions ("A provision in a contract liquidating the damages for breach of the contract") and to codify the case law requirement that the liquidated damages provision reflects a reasonable endeavor to estimate actual damages.

(3) Subdivision (c) of Section 1675 puts the burden on the purchaser of residential property to show the liquidated damages provision is unreasonable to the extent that the amount paid does not exceed five percent of the purchase price. The subdivision places the burden on the seller to show the reasonableness of the liquidated damages provision to the extent that the amount paid exceeds five percent of the purchase price. The tape of the meeting was unclear whether this is what the Commission decided.

(4) Subdivision (b) of Section 1677 establishes type size requirements for a liquidated damages provision in a printed contract to purchase and sell real property. The provision is based on other statutes (cited in the Comment), but the Commission may not wish to retain the "contrasting red print" alternative.

(5) We have included a section--Section 1680--relating to the right to obtain specific performance. We suggest that the word "expressly" in the waiver provision be deleted. The cases look at the language of the contract and the circumstances to determine if the seller has the right of specific performance; an express waiver is not necessarily required. See the discussion set out in Exhibit I attached.

(6) Section 13 defers the operative date of the statute until July 1, 1977--six months after the normal effective date. This provision is recommended since the statute establishes special requirements for printed contracts for the purchase and sale of real property. The deferred operative date will allow time for the State Bar and the California Real Estate Association to develop the necessary form or forms and to have the forms printed.

(7) A major problem with the prior (1974) recommendation was late payment charges on loans secured by real property. Chapter 736 of the Statutes of 1975 enacts Section 2954.4 of the Civil Code to limit the late payment charge on a loan for a single-family, owner-occupied dwelling. See Exhibit II attached. This enactment should eliminate this as a controversial issue with respect to the attached recommendation.

Respectfully submitted,

John H. DeMouilly
Executive Secretary

Extract from People v. Ocean Shore R. R. Co., 90 Cal. App1. 2d 470-471

The test determinative of the question whether a given agreement relating to the sale and purchase of land is an agreement to purchase and sell the property or a mere option to purchase, is: Is the agreement capable of specific performance? 'The nature of a contract as an option or obligation to purchase is to be determined not by the name which the parties have given it, but by the nature of the obligations which it imposes. The distinguishing characteristic of an option contract is that it imposes no binding obligation upon the person holding the option; and where there is not merely the right but the obligation to buy, the contract is not one of option, but of sale.' (12 Am.Jur. 525-6.) 'If an instrument contains a direct agreement to buy it is a contract rather than a mere option, although it . . . provides that if the optionee fails to consummate the agreement his deposit shall be forfeited, or that in case of breach by the optionee the optionor may re-enter and treat all payments made as compensation for use of the premises, unless it also provides that the optionee shall be relieved from any further liability.' (25 Cal.Jur. 508-9; emphasis added.)

"As said in *Asia Investment Co. v. Levin*, 118 Wash. 620 [204 P. 808, 32 A.L.R. 578]: 'It is difficult to lay down a hard and fast rule which will properly classify a given contract. But the law seems to be that, although the contract does not expressly provide that the vendee agrees to consummate the sale by paying the balance and accepting the deed, yet, where it appears that the general intention was to consummate a sale, the absence of an express agreement does not limit the contract merely to one of option, but that it will be held to be a contract of purchase and sale. . . . Or, stated in the language of the decisions, where the stipulation in regard to liquidated damages is to be regarded as security for the performance of the contract by the vendee, then specific performance may be had by the vendor, but where the stipulation was intended as a substitute for performance—where the vendee might comply with the contract or pay liquidated damages in lieu thereof—then specific performance is not available.' (32 A.L.R. pp. 581, 583.) 'Though the intention of the parties to create, on the one hand, an alternative or substitutionary obligation, which will preclude enforcement of specific performance of the main obligation, or, on the other hand, to provide a security for the performance of the main obligation, which will not preclude such relief, does not depend solely upon the phraseology of the provision in respect of payment or forfeiture, but is to be determined in view of the contract as a whole and in the light of surrounding circumstances, nevertheless that phraseology is important in ascertaining intention; and serves to illustrate the practical application of the rule and criterion above stated; and for that reason has been indicated in the two following subdivisions.' (32 A.L.R. pp. 599, 600.) (See also 87 A.L.R. 564.)

"The test, then, as to whether a particular instrument is an option or an agreement of sale is whether the second party is bound to perform so that specific performance will lie, in the event he refuses so to do, and that question is to be determined, not from the name given the instrument, but from the intention of the parties as evidenced by its terms and the circumstances.

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2954.4. (a) A charge which may be imposed for late payment of an installment due on a loan secured by a mortgage or a deed of trust on real property containing only a single-family, owner-occupied dwelling, shall not exceed either (1) the equivalent of 6 percent of the installment due that is applicable to payment of principal and interest on the loan, or (2) five dollars (\$5), whichever is greater. No charge may be imposed more than once for the late payment of the same installment; provided, however, that the imposition of a late charge on any late payment does not eliminate or supersede late charges imposed on prior late payments. A payment is not a "late payment" for the purposes of this section until at least 10 days following the due date of the installment.

(b) No late charge may be imposed on any installment which is paid or tendered in full on or before its due date, or within 10 days thereafter, even though an earlier installment or instalments, or any late charge thereon, may not have been paid in full when due. For the purposes of determining whether late charges may be imposed, any payment tendered by the borrower shall be applied by the lender to the most recent installment due.

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

(d) Nothing in this section shall be construed to alter in any way the duty of the borrower to pay any installment then due or to alter the rights of the lender to enforce the payment of such installments.

(e) 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.

(f) 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.

(g) This section shall apply to loans executed on and after January 1, 1976.

SEC. 2. Section 2954.5 of the Civil Code is amended to read:

2954.5. (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 10 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 least 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 as added by Chapter 1430 of the Statutes of 1970 shall only affect loans made on and after January 1, 1971.

The amendments to this section made at the 1975-76 Regular Session of the Legislature shall only apply to loans executed on and after January 1, 1976.

October 20, 1975

STATE OF CALIFORNIA

**CALIFORNIA LAW
REVISION COMMISSION**

RECOMMENDATION

relating to

Liquidated Damages

November 1975

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

CALIFORNIA LAW REVISION COMMISSION

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To: THE HONORABLE EDMUND G. BROWN JR.
Governor of California and
THE LEGISLATURE OF CALIFORNIA

The California Law Revision Commission was authorized by Resolution Chapter 224 of the Statutes of 1969 to study whether the law relating to liquidated damages should be revised.

The Commission submitted a recommendation on this subject to the 1974 legislative session. Recommendation and Study Relating to Liquidated Damages, 11 Cal. L. Revision Comm'n Reports 1201 (1973). That recommendation was withdrawn for further study by the Commission. In preparing this new recommendation, the Commission has considered the objections made to its earlier recommendation.

Respectfully submitted,
MARC SANDETRON
Chairman

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 severely limit the use of liquidated damages provisions.⁴ In contrast to Civil Code Sec-

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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, 60 Cal. L. Rev. 84 (1972), reprinted in 11 Cal. L. Revision Comm'n Reports at 1229 (1973) (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 931, 986 (1956); Better Food 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 Inv. Corp., 25 Cal. App.3d 766, 102 Cal. Rptr. 340 (1972).
 4. See Background Study.

tions 1670 and 1671, which reflect hostility to liquidated damages provisions, recently enacted statutes such as Section 2718 of the Commercial Code⁵ encourage the use of such provisions.⁶

A liquidated damages provision may serve useful and legitimate functions.⁷ The parties to a contract may include a liquidated damages provision in order to avoid the cost, difficulty, and delay of proving damages in court. 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 are avoided. Also, through a liquidated damages provision, the parties are able by agreement to avoid the perceived inequities of the normal rules of damages. In many cases, the parties may feel that, if they agree on damages in advance, it is unlikely that either will later dispute the amount of damages recoverable as a result of breach.

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 Bus. & Prof. Code § 10242.5 (certain real estate loans); Civil Code §§ 1803.6 (retail installment sales), 2954.4 (loan on single-family, owner-occupied dwelling), 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.

A party who fully intends to perform his obligations under a contract may desire a liquidated damages provision because the amount of the damage caused by a breach by the other party 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 defaulting party may recover the full contract price because losses due to the breach are not provable.

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.⁸

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 and should result in fewer breaches, fewer law suits, and fewer or less extended trials.

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 risk is of particular concern where consumers are involved.

The Commission believes that the use of liquidated damages provisions is beneficial and should be encouraged where the contracting parties have relatively equal bargaining power. In such cases, the provisions serve many useful and socially desirable purposes, particularly

8. See, e.g., *Better Food Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal.2d 179, 253 P.2d 10 (1953)(contract for burglar alarm system with a \$50 liquidation of damages clause).

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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 risk is of particular concern where consumers are involved.

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including avoidance of the cost, the uncertainty, and the delay of litigating the issue of damages. However, existing limitations should be retained and additional protection provided in cases where the parties have substantially unequal bargaining power. Typical of such cases are transactions involving the retail sale of goods, property, or services or the sale of residential housing.

RECOMMENDATIONS

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

General Principles Governing Liquidated Damages

Civil Code Sections 1670 and 1671⁹ should continue to apply to cases where:

(1) The contract is a consumer contract (one for the retail purchase by the party of consumer goods, property, or services primarily for personal, family, or household purposes) and the liquidated damages are sought to be recovered from the consumer; or

(2) The party seeking to invalidate the liquidated damages provision establishes that, at the time the contract was made, he was in a substantially inferior bargaining position.

This would continue the protection now given to significantly weaker and less experienced contracting parties.

The other specific statutes that now apply to particular types of contracts--such as Commercial Code Section 2713--should be retained without change.

9. Civil Code Section 1671 should be amended to insert in the section the court-developed requirement that the liquidated damages provision reflect a reasonable endeavor to estimate the actual damages. See note 3 supra.

A new statutory provision should be enacted to apply to contracts made by parties in relatively equal bargaining positions absent a specific statute that applies to the particular type of contract. In this situation, a contractual stipulation of damages that is reasonable should be valid. The party seeking to invalidate the provision should have the burden of proving that it is unreasonable. 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 suffered would defeat one of the purposes of liquidated damages which is to avoid litigation of the amount of actual damages. This new statutory provision would reverse the basic disapproval of liquidated damages provisions expressed in Sections 1670 and 1671 and in the judicial decisions. Under the new provision, parties with relatively equal bargaining power would be able to develop and agree to a reasonable liquidated damages provision with assurance that the provision will be held valid if it is contested in court. The new statutory provision would not, however, apply against the consumer in a consumer transaction.

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.¹⁰ 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. Thus, the existing restrictive provisions of Sections 1670 and 1671 will continue to apply to a lease for housing for the lessee (a consumer transaction) and to leases where the party seeking to invalidate the liquidated damages provision establishes that, at the time the lease was made, he was in a substantially inferior bargaining position. On the

10. See Cal. Stats. 1969, Res. Ch. 224, at 3388 (directing the Commission to study whether "the law relating to liquidated damages in contracts and, particularly, in leases, should be revised").

other hand, a liquidated damages provision in a lease made by parties in relatively equal bargaining positions will be valid unless shown to be unreasonable.

Land Purchase Contracts

The parties to a contract for the sale and purchase 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 a payment made by the purchaser constitutes liquidated damages if the purchaser fails to complete the sale. The validity of such provisions under existing law is uncertain.¹¹

Separate signing or initialing of liquidated damages clause; size of type. A new section should be enacted to provide that a liquidated damages clause providing the damages if the buyer fails to complete the purchase of real property is valid only if the provision is separately signed or initialed by each party to the contract.¹² If the liquidated damages provision is included in a printed contract, it should be set

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11. See Background Study, 11 Cal. L. Revision Comm'n Reports 1229, 1242-1247 (1973).
 12. The Commission's recommendation in large part would 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) (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.

out in at least 10-point type or in contrasting red print in at least eight-point bold type.¹³ These requirements will alert the parties to the fact that the liquidated damages clause is included in the contract.

Residential housing. Carefully drafted statutory limitations are needed to protect the defaulting buyer of residential housing against oppressive use of a liquidated damages provision. A provision liquidating damages for the buyer's default in a contract for the sale of residential property (a dwelling consisting of not more than four residential units, one of which the buyer intends to occupy) should be valid only if it designates all or part of the buyer's payment as liquidated damages. In such contracts, only the amount actually paid by the buyer in the form of cash or check (including a postdated check) would be considered valid liquidated damages even where the liquidated damages clause designates a larger amount. This provision recognizes that in most cases even the unsophisticated buyer of residential housing expects that he will lose the deposit actually made if he does not go through with the deal. Nevertheless, the buyer of residential property should be protected from forfeiting an unreasonably large amount as liquidated damages. A five-percent-of-purchase-price standard should be adopted. If the amount paid is not in excess of five percent, the provision making the payment liquidated damages should be valid unless the buyer establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. To the extent the amount paid by the buyer exceeds five percent of the purchase price, the seller should have the burden to establish that the liquidated damages provision was reasonable under the circumstances existing at the time the contract was made.

Other types of real property. Where the contract is for the sale and purchase of real property (other than residential housing described above), a provision in the contract liquidating the damages should be

13. This requirement is based on comparable provisions in recently enacted statutes. See Civil Code § 2984.1 (contrasting red print in at least eight-point bold type required in contract provision regarding insurance coverage in conditional sales contract). See also Civil Code §§ 1803.2 and 1803.7 (retail installment contracts), 1916.5 (variable interest provision), 2984.3 (buyer's acknowledgment of delivery of copy of conditional sales contract).

valid if it satisfies the formal requirements as to signing or initialing and size of type and either of the following requirements:

(1) The liquidated damages provision satisfies the general requirements for a valid liquidated damages provision as outlined above. Thus, the existing restrictive provisions Sections of 1670 and 1671 would continue to apply where the party seeking to invalidate the liquidated damages provision establishes that, at the time the contract was made, he was in a substantially inferior bargaining position. On the other hand, if the parties are in relatively equal bargaining positions, the liquidated damages provision will be valid under the more liberal general standard recommended above unless shown to be unreasonable.

(2) Where the parties to the contract for the sale and purchase of the real property provide that all or any part of a payment made by the buyer shall constitute liquidated damages to the seller if the buyer fails to complete the purchase of the property, such amount--to the extent it is actually paid by the buyer--is valid as liquidated damages unless the buyer establishes that the liquidated damages provision was unreasonable under the circumstances existing at the time the contract was made.

These more liberal provisions, which will apply only to real estate purchase contracts other than for residential housing, will provide parties in relatively equal bargaining positions with assurance that a reasonable liquidated damages provision will be held valid if contested in court.

Requirement for subsequent payments. Frequently a payment is made at the time of the agreement to sell and to purchase real property and a second payment is made at the time the escrow is opened on the transaction. So that the purchaser will be aware that any payment after the first one may also be retained by the seller as liquidated damages, a separate signing or initialing of the liquidated damages provision should be required for each such subsequent payment.

Right to obtain specific performance. The use of a liquidated damages provision makes retention of the buyer's payment the seller's

sole right to damages. Theoretically, the seller still has the alternative remedy of specific performance,¹⁴ but in most instances the difficulties in obtaining specific performance make it an unsatisfactory and unused remedy.¹⁵ Nevertheless, a provision is included in the recommended legislation to make clear that a liquidated damages provision does not affect any right a party may have to obtain specific performance.

Operative Date

Because the recommended legislation establishes new requirements for the form of a liquidated damages provision in a printed contract to purchase and sell real property, the operative date of the recommended legislation should be deferred until July 1, 1977. Deferring the operative date six months will provide time within which to develop and print the necessary form contracts.

Technical Revisions

Additional technical revisions are recommended. These are explained in the Comments which follow the sections of the recommended legislation. One technical revision made by the recommended legislation is to split out the liquidated damages sections into a separate title. An outline of revised Title 4 and new Title 4.5 is set out below.¹⁶

TITLE 4. UNLAWFUL CONTRACTS

- § 1667. Unlawfulness defined
- § 1668. Contracts contrary to policy of law
- § 1669. Contracts in restraint of marriage

TITLE 4.5. LIQUIDATED DAMAGES

Chapter 1. General Provisions

- § 1670. Liquidated damages provision void unless authorized by statute

14. Civil Code § 3389. See also California Real Estate Secured Transactions, Hetland, "Land Contracts" § 3.21 (Cal. Cont. Ed. Bar 1970).

15. See California Real Estate Sales Transactions, Bernhardt, "Liability for Breach" §§ 11.62-11.67 (Cal. Cont. Ed. Bar 1967); California Real Estate Secured Transactions, Hetland, "Land Contracts" §§ 3.21-3.33, 3.52-3.57 (Cal. Cont. Ed. Bar 1970).

16. It is necessary to renumber existing Civil Code Section 1676 to be Section 1669 in order to accommodate new Title 4.5. No change is made in the wording of the section.

- § 1671. Requirements for liquidated damages generally
- § 1672. Contracts between parties in relatively equal bargaining positions
- § 1673. Other statutes not affected

Chapter 2. Buyer's Default on Real Property Purchase Contract

- § 1675. Contracts to purchase residential property
- § 1676. Contracts to purchase other real property
- § 1677. Separate signing or initialing; additional requirement for printed contracts
- § 1678. Separate signing or initialing for subsequent payments
- § 1679. Chapter applies only to liquidated damages if buyer fails to purchase
- § 1680. Right to obtain specific performance
- § 1681. Real property sales contracts excluded

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PROPOSED LEGISLATION

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

An act to amend Sections 1670, 1671, 1951.5, and 3358 of, to add Sections 1669, 1672, and 1673 to, to add a title and chapter heading immediately preceding Section 1670 of, to add Chapter 2 (commencing with Section 1675) to Part 2 of Division 3 of, and to repeal Section 1676 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 § 1669 (technical addition)

SECTION 1. Section 1669 is added to the Civil Code, to read:

1669. Every contract in restraint of the marriage of any person, other than a minor, is void.

Comment. Section 1669 continues without change former Section 1676.

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Title and Chapter Heading (added)

SEC. 2. A title heading and chapter heading is added immediately preceding Section 1670 of the Civil Code, to read:

TITLE 4.5. LIQUIDATED DAMAGES

CHAPTER 1. GENERAL PROVISIONS

Civil Code § 1670 (technical amendment). Liquidated damages provision void unless authorized by statute

SEC. 3. Section 1670 of the Civil Code is amended to 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~~ by statute .

Comment. The amendment to Section 1670 recognizes that there are numerous statutory exceptions to the rule stated in Section 1670. See the Comment to Section 1673.

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Civil Code § 1671 (amended). Requirements for liquidated damages generally

SEC. 4. Section 1671 of the Civil Code is amended to read:

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;~~ A provision in a contract liquidating the damages for breach of the contract is valid when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage and the provision reflects a reasonable endeavor to estimate actual

Comment. Section 1671 is amended to add an additional requirement (that the liquidated damages provision reflects a reasonable endeavor to estimate the actual damages) developed by the courts in interpreting and applying Section 1671. E.g., McCarthy v. Tally, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956); Better Food 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. Apptr. 340 (1972). The addition of the court developed requirement makes no substantive change in the law. It should be noted that Section 1671 is not applicable where the validity of the liquidated damages provision is determined by another statute expressly applicable to the contract. See Section 1673 and Comment thereto.

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Civil Code § 1672 (added). Contracts between parties
in relatively equal bargaining positions

SEC. 5. Section 1672 is added to the Civil Code, to read:

1672. (a) A provision in a contract liquidating the damages for breach of the contract is valid under this section unless the party seeking to invalidate the provision establishes either of the following:

(1) The provision was unreasonable under the circumstances existing at the time the contract was made.

(2) The party from whom the liquidated damages are sought to be recovered was in a substantially inferior bargaining position at the time the contract was made.

(b) This section does not apply where liquidated damages are sought to be recovered from a party to a contract for the retail purchase by such party of consumer goods, property, or services, and such goods, property, or services were purchased by such party primarily for personal, family, or household purposes.

liquidated

Comment. Section 1672 provides that a reasonable ~~damages~~ provision in a contract is valid, but the section does not apply against a party who establishes that he was in a substantially inferior bargaining position at the time the contract was made or against the consumer in a consumer case.

In the cases where Section 1672 applies, the burden of proof on the issue of reasonableness is on the party seeking to invalidate the provision. The section thus reflects a policy that favors the use of liquidated damages provisions, reversing the restrictive policy of Sections 1670 and 1671.

Section 1672 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.

Section 1671 permits liquidated damages only where the actual damages "would be impracticable or extremely difficult to fix" and the liquidated damages provision reflects a "reasonable endeavor" to estimate the probable damages. Section 1672, however, 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 the relationship that the damages provided in the contract 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, whether the parties were represented by lawyers at the time the contract was made, the anticipation of the

parties that proof of actual damages would be costly or inconvenient, the difficulty of proving causation and foreseeability, and whether the liquidated damages provision is included in a form contract.

Section 1672 does not make valid a liquidated damages provision where the party from whom the liquidated damages are sought to be recovered establishes that he was in a substantially inferior bargaining position at the time the contract was made. See subdivision (a)(2). In making this determination, all the circumstances existing at the time of the making of the contract are considered including, but not limited to, whether the party was represented by a lawyer at the time the contract was made. If the party establishes that he was in a substantially inferior bargaining position at the time the contract was made, the validity of the liquidated damages provision is determined under Section 1671. It should be noted that, where the party seeking to avoid the liquidated damages provision is the superior party in the case of substantially disparate bargaining position, Section 1672 is applicable.

Subdivision (b) of Section 1672 makes the section not applicable against the consumer where the contract is for consumer goods, property, or services for use by the consumer as a consumer. Where the party seeking to avoid the liquidated damages provision is the nonconsumer party, Section 1672 is applicable.

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 1671 or Section 1672 controls this determination. Contrast Sections 1675-1681 ("earnest money deposits). On the other hand, the deposit may be nothing more than a fund to secure the payment of actual damages if any are recovered. 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 1672 does not affect other statutes that govern liquidation of damages for breach of certain types of contracts. See Section 1673.

969/009

Civil Code § 1673 (added). Other statutes not affected

SEC. 6. Sections 1671 and 1672 do not apply where the validity of the liquidated damages provision is determined by another statute expressly applicable to the contract.

Comment. Section 1673 makes clear that Sections 1671 and 1672 do not affect other statutes that govern liquidation of damages for breach of certain types of contracts. E.g., Civil Code §§ 1675-1681 (buyer's default on contract to purchase real property); Com. Code § 2713 (Commercial Code transactions). For late payment charge provisions, see, e.g., Bus. & Prof. Code § 10242.5 (certain real estate loans); Civil Code §§ 1803.6 (retail installment sales), 2954.4 (loan on single-family, owner-occupied dwelling), 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 Sections 1671 or 1672--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 1671 or Section 1672 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 53069.35 (allowing cities, counties, and districts to include in a contract a charge for late completion) remain unaffected by Sections 1670-1672. Note that Section 1676, providing a rule governing liquidated damages for the buyer's default on a contract for the sale of nonresidential real property, incorporates Section 1671 or Section 1672.

969/025

Civil Code § 1676 (technical repeal)

SEC. 7. Section 1676 of the Civil Code is repealed.

~~1676. Every contract in restraint of the marriage of any person, other than a minor, is void.~~

Comment. Section 1676 is continued without change in Section 1669.

069/040

CHAPTER 2. BUYERS'S DEFAULT ON REAL PROPERTY PURCHASE CONTRACT

SEC. 8. Chapter 2 (commencing with Section 1675) is added to Title 4.5 of Part 2 of Division 3 of the Civil Code, to read:

CHAPTER 2. BUYER'S DEFAULT ON REAL PROPERTY
PURCHASE CONTRACT

069/047

Civil Code § 1675 (added). Contract to purchase residential property

1675. (a) As used in this section, "residential property" means a dwelling that meets both of the following requirements:

(1) The dwelling contains not more than four residential units.

(2) At the time the contract to purchase and sell the property is made, the buyer intends to occupy the dwelling or one of its units as his residence.

(b) Where the parties to a contract to purchase and sell residential property provide in the contract that all or any part of a payment made by the buyer shall constitute liquidated damages to the seller if the buyer fails to complete the purchase of the property, such amount is valid as liquidated damages to the extent that it is actually paid in the form of cash or check (including a postdated check) and satisfies the requirements of Sections 1677 and 1678 and this section.

(c) The amount paid is valid as liquidated damages to the extent it does not exceed five percent of the purchase price unless the buyer establishes that the liquidated damages provision was unreasonable under the circumstances existing at the time the contract was made. The amount paid is valid as liquidated damages to the extent it exceeds five

percent of the purchase price if the seller establishes that the liquidated damages provision was reasonable under the circumstances existing at the time the contract was made.

Comment. Section 1675 governs the validity of a provision liquidating the damages for the buyer's default in a contract to purchase and sell residential property as defined in subdivision (a). The section is an exception to the general provisions of sections 1670-1673. The liquidated damages provision is valid only if it is separately signed or initialed by the parties as required by Sections 1677 and 1678. The section does not apply to real property sales contracts as defined in Section 2985 (see Section 1681).

Subdivision (b) makes clear that a provision liquidating the damages if the buyer defaults is valid only to the extent that the buyer has actually paid in the form of cash or a check (including a postdated check) the amount of the liquidated damages. Hence, if the liquidated damages provision specifies liquidated damages for the buyer's default in an amount greater than the amount actually paid by the buyer, the provision is valid only to the extent of the amount actually paid; the seller may not enforce the greater amount under Sections 1670-1673. Where the amount paid is greater than the amount specified as liquidated damages, only the amount so specified may be retained as liquidated damages for the buyer's default. Section 1675 recognizes that generally the buyer of residential housing, including the buyer who does not read the contract or does not understand it, expects that he will lose the amount actually paid if he does not complete the purchase of the property.

Subdivision (c) is designed to protect the buyer of residential housing from forfeiting an unreasonably large amount as liquidated damages. The subdivision provides a five-percent-of-purchase-price standard. If the amount paid is not in excess of five percent, the buyer has the burden to establish that the liquidated damages provision was unreasonable "under the circumstances existing at the time the contract was made." To the extent that the amount paid exceeds five percent of the purchase price, the burden is placed on the seller to establish that the liquidated damages provision was reasonable "under

the circumstances existing at the time the contract was made." As to the interpretation of "under the circumstances existing at the time the contract was made," see the discussion in the Comment to Section 1672.

Section 1675 does not apply to contract provisions concerning anything other than liquidated damages for the buyer's failure to purchase the property (see Section 1679). The section does not, for example, apply to a provision liquidating the damages if the seller fails to perform. Nor does the section affect the seller's right to obtain specific performance (see Section 1630).

Where a liquidated damages provision is valid under this section, the limitations of Section 3307 (damages for breach of agreement to purchase real estate) do not apply.

406/191

Civil Code § 1676 (added). Contract to purchase other real property

1676. (a) Except as provided in Section 1675, a provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to purchase the property is valid if it satisfies the requirements of Sections 1677 and 1678 and the requirements of either subdivision (b) or (c).

(b) The liquidated damages provision is valid if it satisfies the requirements of Section 1671 or, when the contract is one covered by Section 1672, the requirements of that section.

(c) Where the parties to the contract provide that all or any part of a payment made by the buyer shall constitute liquidated damages to the seller if the buyer fails to purchase the property, such amount is valid as liquidated damages to the extent that it is actually paid in the form of cash or check (including a postdated check) unless the buyer establishes that the liquidated damages provision was unreasonable under the circumstances existing at the time the contract was made.

Comment. Section 1676 provides for the validity of a liquidated damages provision for the buyer's default in a contract for the sale of real property other than residential property as defined in subdivision (a) of Section 1675. The liquidated damages provision is valid only if it is separately signed or initialed by the parties as required by Sections 1677 and 1678. The section does not apply to real property sales contracts as defined in Section 2985 (see Section 1681).

Section 1676 requires that the liquidated damages provision must satisfy the requirements of Section 1671 or, where applicable, the requirements of Section 1672, except to the extent that the buyer has actually paid in the form of cash or a check (including a postdated check) the amount of the liquidated damages. With respect to requirements of Sections 1671 and 1672, see those sections and the Comments thereto. Note that subdivision (c) gives presumptive validity to a liquidated damages provision to the extent that the buyer has actually paid such amount. The subdivision protects the buyer from forfeiting an unreasonably large amount as liquidated damages by permitting the buyer to invalidate the liquidated damages provision by establishing that it was "unreasonable under the circumstances existing at the time the contract was made." As to the interpretation of the quoted phrase, see the discussion in the Comment to Section 1672.

Section 1676 does not apply to contract provisions concerning anything other than liquidated damages for the buyer's failure to purchase the property (see Section 1679). The section does not, for example, apply to a provision liquidating the damages if the seller fails to perform. Nor does the section affect the seller's right to obtain specific performance (see Section 1680).

Where a liquidated damages provision is valid under this section, the limitations of Section 3307 (damages for breach of agreement to purchase real estate) do not apply.

406/193

Civil Code § 1677 (added). Separate signing or initialing; additional requirement for printed contracts

1677. A provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to purchase the

property is invalid unless:

(a) It is separately signed or initialed by each party to the contract; and

(b) If it is included in a printed contract, it is set out either in at least 10-point type or in contrasting red print in at least eight-point bold type.

Comment. Section 1671 establishes formal requirements for execution of a provision liquidating the damages if the buyer defaults in his agreement to purchase real property. The provision is invalid unless separately signed or initialed by each party to the contract. This requirement is adopted from 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. The requirement is extended to all contracts providing for the forfeiture of payments as liquidated damages to the seller if the buyer fails to complete the purchase. This will make it more likely that the parties will appreciate the consequences of this important provision. See also Section 1678 (separate signing or initialing for subsequent payments). The requirement of a separate signing or initialing provided by this section does not apply to anything other than liquidated damages for the buyer's failure to purchase the property.

Section 1677 also establishes minimum type size for a provision in a printed contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to purchase the property. The type size requirements are designed to assure further that the parties will be aware of the consequences of the liquidated damages provision. The standard which requires contrasting red print in at least eight-point bold type is taken from Section 2984.1 of the Civil Code (contract provision regarding insurance coverage in conditional sales contract). The alternative standard (which requires at least 10-point type) is comparable to that found in various other recently enacted statutes. E.g., Civil Code §§ 1803.2 and 1803.7 (retail installment contracts), 1916.5 (variable interest provision), 2984.3 (buyer's acknowledgement of delivery of copy of conditional sale contract--'at least 10-point bold type').

406/194

Civil Code § 1678 (added). Separate signing or initialing for subsequent payments.

1678. If more than one payment is made by the buyer to constitute liquidated damages under Section 1675 or subdivision (c) of Section 1676, the amount of any payment after the first payment is valid as liquidated damages only if (1) it satisfies the requirements of Section 1675 or subdivision (c) of Section 1676, whichever applies, and (2) a separate liquidated damages provision satisfying the requirements of Section 1677 is separately signed or initialed by each party to the contract for each such subsequent payment.

Comment. Section 1678 is included to protect the buyer by requiring a separately signed or initialed agreement if any payment made after the first payment is to be liquidated damages if the buyer fails to purchase real property. The section recognizes that frequently a deposit is made at the time the agreement to sell and to purchase the property is made and a second payment is made at the time the escrow is opened on the transaction. The payment made at the time the escrow is opened can be retained by the seller as liquidated damages only if there is a valid agreement so providing and there is a separate signing or initialing for the subsequent payment.

406/195

Civil Code § 1679. Chapter applies only to liquidated damages if buyer fails to purchase property

1679. This chapter applies only to a provision for liquidated damages to the seller if the buyer fails to purchase real property. The validity of any other provision for liquidated damages in a contract to purchase and sell real property is determined under Section 1671 or, when the contract is one covered by Section 1672, under that section.

Comment. Section 1679 makes clear that this chapter does not apply to contract provisions concerning anything other than liquidated damages for the buyer's failure to purchase the property. The chapter does not apply, for example, to a provision liquidating the damages if the seller fails to perform. Nor does the chapter affect the seller's right to obtain specific performance (see Section 1680).

406/196

Civil Code § 1680 (added). Right to obtain specific performance

1680. Nothing in this chapter affects any right a party to a contract for the purchase and sale of real property may have to obtain specific performance. The inclusion of a liquidated damages clause in such a contract does not affect the right to obtain specific performance, but nothing in this chapter limits the right of the parties to include in the contract a provision that [expressly] waives the right of a party to obtain specific performance of the contract and makes damages the sole remedy of the party.

Comment. Section 1680 makes clear that this chapter does not affect the rule under existing California law that the right of the seller to obtain specific performance of a contract for the purchase of real property is not affected by the inclusion in the contract of a provision liquidating the damages to the seller if the buyer defaults on his agreement to purchase the property. See Civil Code Section 3389 and cases interpreting that section. The section recognizes that the contract may include a waiver by the seller of the right to obtain specific performance of the buyer's obligation to purchase the property and make damages the seller's sole remedy.

Although the seller--absent a waiver--still has the alternative remedy of specific performance, in most instances the difficulties in obtaining specific performance make it an unsatisfactory and unused remedy. See California Real Estate Sales Transactions, Bernhardt, "Liability for Breach" §§ 11.62-11.67 (Cal. Cont. Ed. Bar 1967); California Real Estate Secured Transactions, Hetland, "Land Contracts"

§§ 3.21-3.33, 3.52-3.57 (Cal. Cont. Ed. Bar 1970). Nevertheless, the alternative remedy of specific performance would be useful to the seller, for example, where the buyer is financially responsible, the property substantially decreases in value after the contract to buy and sell is executed, and the liquidated damages provided in the contract will be substantially less than the seller's actual loss if the buyer fails to complete the purchase.

406/197

Civil Code § 1681. Real property sales contracts excluded

1681. This chapter does not apply to real property sales contracts as defined in Section 2985.

Comment. Section 1681 makes clear that this chapter does not apply to real property sales contracts as defined in Section 2985 (commonly called installment land contracts). No change is made in the law that governs the extent to which payments made pursuant to such contracts may be forfeited upon the buyer's default.

406/198

Civil Code § 1951.5 (technical amendment)

SEC.9. Section 1951.5 of the Civil Code is amended to read:

1951.5. Sections 1670 and 1671, relating to liquidated damages, apply to a lease of real property except that Section 1672 applies where the lease is one covered by that section .

Comment. Section 1951.5 is amended to reflect the addition of Civil Code Section 1672.

406/199

Civil Code § 3358 (technical amendment)

SEC. 10. Section 3358 of the Civil Code is amended to read:

3358. ~~Notwithstanding the provisions of this Chapter,~~ Except as

expressly 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. See the Comment to Section 1673.

100/891

Government Code § 14376 (technical amendment)

SEC. 11. 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. Sections 1670 to 1672, inclusive, of the Civil Code do not apply to contract provisions under this section.

Comment. The last sentence is added to Section 14376 to make clear that Civil Code Sections 1670-1672 have no effect on contract provisions under Section 14376.

100/892

Government Code § 53069.85 (technical amendment)

SEC. 12. 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. Sections 1670 to 1672, inclusive, of the Civil Code do not apply to contract provisions under this section.

Comment. The last sentence is added to Section 53069.85 to make clear that Civil Code Sections 1670 to 1672 have no effect on contract provisions under Section 53069.85.

406/200

Operative Date

SEC. 13. This act becomes operative on July 1, 1977.

Comment. The deferred operative date will allow time for development and printing of form contracts for the purchase and sale of real property. The act establishes requirements for the form of such contracts.