

Memorandum 76-109

Subject: Study 72 - Liquidated Damages

Background

Assembly Bill 3169 (liquidated damages) passed the Legislature at the 1976 session but was vetoed by the Governor. This memorandum presents background information necessary to enable the Commission to decide what changes, if any, should be made in AB 3169 in submitting a new bill to the 1977 Legislature. A copy of AB 3169 in the form in which it passed the Legislature (together with the official Comments from the Commission recommendation or Senate Committee report) is attached (white pages). Also attached is a copy of the printed recommendation that led to AB 3169. Also attached (green) is the Senate Committee Analysis of AB 3169 as it passed the Legislature.

The problem sections are Sections 1675 and 1676 on pages 4-6 of the attached bill. The staff hopes that the Commission will give some thought to how these sections might be modified in light of the Governor's veto.

State Bar

The Board of Governors of the State Bar of California at its August 1976 meeting approved the recommendations of the Committee on Administration of Justice, and recommendation of the Board Committee on Legislation thereon, that the Commission's proposed legislation be approved and directed that the report of the committee be forwarded to the Commission. The report of the committee is attached as Exhibit A [so designated by the State Bar]. It is to be noted that this report approves the proposed legislation at a time when a two-percent-of-purchase-price standard was used to determine which party had the burden of proving reasonableness in a residential real estate sales contract. This was subsequently raised by an Assembly Committee amendment to three percent. See Section 1675(c) in attached copy of bill.

On the issue that gave rise to the Governor's veto--the provisions relating to real property sales contracts--the State Bar Committee analysis set out in Exhibit A contains several misstatements. First, in the

case of a residential sale, the damages are not limited to two percent as stated in the Committee report; two percent was the point at which the burden shifted from the buyer to the seller to prove the reasonableness of the liquidated damages under all the circumstances existing at the time the contract was made. See Section 1675(c) in attached copy of bill. Second, in the case of other types of real property sales contracts, the liquidated damages are not limited to all or part of the payment actually made as stated in the Committee report; the liquidated damages can be merely promised and not actually paid or deposited and still be enforced if reasonable.

Governor's Veto

The Governor vetoed the bill on the ground that it was unreasonable for the seller to retain the earnest money deposit in times like these when the value of real property is rising so rapidly. We have made a number of calls to Bob Williams in the Governor's office to determine if the objections the Governor had were more precise than as stated above. However, Mr. Williams is very busy and, although he has promised to check the matter out and call, he had not been able to do so by the time this memorandum was written. Perhaps we will have more to report at the meeting.

Some Possible Alternatives

It should be remembered that the proposed legislation passed the Legislature in 1976. In addition, we now have the support of the California State Bar, at least at a two-percent-of-purchase-price level with respect to the controversial provision. It is true, however, that there is some lack of understanding on the part of the State Bar as to what the proposal actually does. In view of this situation, one course of action would be to submit a new bill in the form in which it passed the 1976 Legislature with the three percent reduced to two percent.

The major problem with Sections 1675 and 1676 is that they do not permit a defaulting buyer to introduce evidence of the fact that the property was thereafter sold within a short time at a substantially higher price than offered by the defaulting buyer. Under the bill, the reasonableness of the amount as liquidated damages is determined "under

the circumstances existing at the time the contract was made." As the Comment to Section 1671 points out (bottom of page 2 and top of page 3 of bill), "the amount of damages actually suffered has no bearing on the validity of the liquidated damages provision." Consideration might be given to permitting the reasonableness of the liquidated damages provision to be determined (at least in the case of residential property) by considering also the amount of damages actually suffered. The staff does not believe that this would necessarily lead to a lot of litigation. If the amount of damages are within the two-percent-of-purchase-price standard, the burden of showing unreasonableness would be on the defaulting buyer, the seller would have the deposit which constitutes the liquidated damages in his hands, and the defaulting buyer would be in the position of having to bring a legal action to recover the deposit. Whether consideration of the damages actually suffered would be appropriate for consideration in the case of nonresidential real property sales is a different question the Commission also should consider.

Consideration might be given to requiring the seller to establish the reasonableness of the liquidated damages in every case. This is basically existing law. As previously indicated, we doubt that many actions would be brought to recover deposits by defaulting buyers of residential property. (The experience under existing law would be relevant here.)

Conclusion

In conclusion, the staff believes that this proposal has had a lot of work and has a lot of support both from organizations such as the State Bar and California Association of Realtors and from individual lawyers who wrote us indicating their support. Unfortunately, it was vetoed by the Governor. The Commission should not abandon this subject. The question is what revisions, if any, should be made in AB 3169 to provide some assurance that the 1977 bill will be approved by the Governor.

Respectfully submitted,

John H. DeMouly
Executive Secretary

II

LAW REVISION COMMISSION PROPOSALS

(1) CC 1667-1681 - Liquidated Damages

Reference: CAJ Annual Report, 1975; A.B. 3169

Present law provides that liquidated damages for breach of a contract can only be recovered where actual damages would be impractical or extremely difficult to fix (CC 1670, 1671) and where such damages reflect a reasonable endeavor to estimate actual damages. The Law Revision Commission believes that a liquidated damages provision may serve several useful functions and should be encouraged where the contracting parties have relatively equal bargaining power. Among the benefits it sees are (1) avoiding the problems of proving damages in court, (2) avoiding the problems of proving causation and foreseeability, (3) avoiding the inequities of the normal rules of damages, (4) reducing litigation as to the amount of damages recoverable on breach, (5) avoiding situations where damages cannot be proved under normal damage rules, (6) permitting a party to limit his liability for his own breach, and (7) will result in fewer breaches of contracts. The Commission recognizes there are risks and to take care of those situation recommends that present rules apply and additional protections be provided in cases where parties have substantially unequal bargaining power, especially in transactions involving the sale or lease of personal property or services to consumers and the sale or lease of residential housing. An earlier proposal in this area was disapproved by your Board on the general ground that it did not offer sufficient protection to the "little" people (see CAJ Annual Report, 1975). The present proposal attempts to meet that objection by specifically exempting contracts for consumer goods and services and residential leases and adding protection for residential sales contracts. It has been introduced in the legislature as A.B. 3169. Copies of the bill are not included but will be available at your meeting.

The protection afforded residential sales contracts (dwelling of not more than four residential units, one of which the buyer intends to occupy) consists of (1) requiring the provision for liquidated damages be in 10 point type or red print and separately signed or initialed, and (2) limiting the damages to all or part of the down payment or deposit not to exceed 2% of the purchase price. As to other types of real property sales contracts, the proposal provides that liquidated damages clauses are valid if separately signed or initialed, if the damages are reasonable under the circumstances.

This is not correct
S.D.

existing at the time the contract was made [and are limited to all or part of the payment actually made].

In essence, the proposal provides that a provision for liquidated damages is valid unless the party seeking to invalidate it establishes that the provision was unreasonable under the circumstances existing at the time the contract was made, except that where damages are sought from a party to a contract for the retail purchase, or rental, of personal property or services primarily for the party's personal, family or household purposes or from a party to a lease of real property for use as a dwelling by the party, the provision shall be void (although the parties may agree that such amount is presumed to be the amount of damage sustained by a breach).

With one dissent the committee recommends your Board approve and support this LRC proposal but that the attention of the Commission be directed to the recent case of United Savings & Loan v. Reeder Development Corp. (57 CA3d 282) which seems to hold that in determining the validity of liquidated damage clauses the court should use the "hindsight" test. This is in conflict with the LRC proposal and although the committee agrees that this does not preclude a contrary legislative enactment, it feels that the Commission should consider specifically resolving the conflict, either through an amendment or by way of an official comment.

SENATE COMMITTEE ON JUDICIARY

1975-76 REGULAR SESSION

AB 3169 (McAlister)
As amended June 2
Various Codes

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B

LIQUIDATED DAMAGES

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HISTORY

Source: California Law Revision Commission

Prior Legislation: SB 1532 (1975) - held in this committee

Support: Calif. Ass'n. of Realtors

Opposition: No Known

DIGEST

Limits a provision of existing law, under which a contractual "liquidated damages" provision is void unless the parties to the contract agree upon an amount which is presumed to be the amount of damages sustained by a breach thereof when it would be impracticable or extremely difficult to fix the actual damage, to situations in which the liquidated damages are sought to be recovered from either of the following:

- (1) A party to a contract for the purchase or rental of consumer goods or services.
- (2) A party to a lease of residential real property. (Sec. 1670 & subds. (c) & (d), Sec. 1671, Civ. C.)

Provides that all other contractual liquidated damages provisions for the breach of a contract, except those to which another statute expressly applies, are valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made (subd.

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(b), Sec. 1671, Civ. C.).

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Prescribes the following rules, among others, to govern the enforceability of liquidated damage provisions in real property purchase contracts:

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(1) Where the provision appears in a contract for the purchase of residential property and provides that all or part of a payment made by the buyer shall constitute liquidated damages if the buyer fails to complete the purchase, it is valid if it meets the following requirements:

(a) The amount must be actually paid in the form of cash or check.

(b) The amount paid must not exceed 3% of the purchase price or, if it does, the seller must establish that the excess is reasonable.

(c) It must be separately signed or initialed by each party and meet specified requirements relating to typeface (Sec. 1677, Civ. C.).

(d) Each payment made after the first payment must have a separately signed liquidated damages provision, and the aggregate of liquidated damages may not exceed 3% of the purchase price, unless the seller establishes that the excess is reasonable (Sec. 1678, Civ. C.). (subd. (b), Sec. 1675, Civ. C.)

(2) A seller's liquidated damages provision in a contract for the purchase and sale of non-residential real property is valid unless one of the following facts exists:

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| (a) The provision is not separately signed. | 3
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| (b) It does not comply with requirements relating to boldness of typeface. | 9 |
| (c) The party seeking to invalidate the provision establishes that it was unreasonable under the circumstances existing at the time the contract was made. (Sec. 1675, Civ. C.) | |

Provides that the bill does not affect or apply to either of the following:

- (1) Actions for specific performance
- (2) Real property sales contracts which do not require conveyance of title within one year from the date of formation of the contract. (Secs. 1680 & 1681, Civ. C.)

Provides that, with respect to the following contracts, an amount fixed as liquidated damages is valid unless manifestly unreasonable under the circumstances existing at the time the contract was made:

- (1) State public works contracts (Sec. 14376, Gov. C.).
- (2) Public projects contracts of cities, counties, and districts (Sec. 53069.85, Gov. C.).
- (3) Contracts for municipal improvements under the Improvement Act of 1911 (Sec. 5254.5, S. & H.C.).

Prescribes the following rules, among others, to govern liquidated damages provisions in contracts for construction projects for the University of California:

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| (1) The Regents may include or cause to be included in such contracts, a provision establishing the time within which the whole or any specified portion of the work must be completed. | 3
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| (2) The provision may provide for liquidated damages for each day completion is delayed beyond the specified time. | |
| (3) The provision is valid unless manifestly unreasonable under the circumstances existing at the time the contract was made. | |
| (4) The contract may provide for the payment of a bonus for early completion. (Sec. 23190, Ed. C.) | |

Makes technical, clarifying, and conforming changes (Secs. 1669, 1670, 1676, 1951.15, & 3358, Civ. C.).

Operative July 1, 1977.

PURPOSE

Replace the existing rule under which contractual liquidated damages provisions are presumed invalid, with a rule under which, in commercial transactions, such provisions are presumed valid.

COMMENT

1. Under present law, all contractual liquidated damages provisions not otherwise governed expressly by statute are governed by Sections 1670 and 1671 of the Civil Code, under which such provisions are void, except that the parties to a contract may agree therein upon an amount

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which is presumed to be the amount of damages 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
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In addition, the courts have developed a second requirement that the provision must reflect a "reasonable endeavor" to estimate actual damages. (California Law Revision Commission, Recommendation relating to Liquidated Damages, November 1975, p. 2143).

This bill would limit the existing rule to consumer contracts and residential tenancies, and would divide all other contracts into five categories, for purposes of the enforceability of liquidated damages provisions. These categories, and the rules applicable to each, would be as follows:

- (a) Contracts as to which another statute expressly prescribes the rules or standard for determining the validity of a liquidated damages provision. Included within this category would be, for example, defaults on real property purchase contracts (Secs. 1675 to 1681, inclusive, Civ. C.); sales of goods (Sec. 2718, Com C.); and late payments on certain real estate loans (Sec. 10242.5, B. & P.C.), retail installment contracts (Sec. 1803.6, Civ. C.), second-mortgage loans (Sec. 2954.4, Civ. C.), and automobile conditional sales contracts (Sec. 2982, Civ. C.).

An important feature of this bill is that the categories listed below comprise only transactions not otherwise expressly governed by statute.

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- (b) Contracts for the purchase and sale of residential real property. 3
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A seller's liquidated damages provision is invalid unless it meets both of the following requirements:

- (1) Where the contract provides that payments made by the buyer constitute liquidated damages, the amount must be actually paid in the form of cash or check.
- (2) The provision must be separately signed or initialed by each party, and meet specified requirements relating to typeface.

If these requirements are met, then the applicable rule depends on whether the amount of liquidated damages exceeds 3% of the purchase price.

- (1) If it does not exceed 3%, it is valid unless the buyer establishes that the amount was unreasonable under the circumstances existing at the time the contract was made.
- (2) If it exceeds 3%, it is invalid unless the seller establishes that the excess was reasonable.

A buyer's liquidated damages provision is governed by the rule stated in (e), below.

- (c) Contracts for the purchase and sale of non-residential real property.

A seller's liquidated damages provision is invalid unless it meets both of the following

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requirements:

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(1) Where the contract provides that payments made by the buyer constitute liquidated damages, the amount must be actually paid in the form of cash or check.

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(2) The provision must be separately signed or initialed by each party, and meet specified requirements relating to typeface.

If these requirements are met, then the provision is valid unless the party seeking to invalidate it establishes that it was unreasonable under the circumstances existing at the time the contract was made.

A buyer's liquidated damages provision is governed by the rule stated in (e), below.

(d) Contracts for public construction projects entered into by local governments, the state, or the University of California. The provision is valid unless manifestly unreasonable under the circumstances existing at the time the contract was made.

(e) All other transactions. A liquidated damages provision is valid unless it is shown that the provision was unreasonable under the circumstances existing at the time the contract was made.

2. Stated another way, the bill would prescribe 4 different rules relating to the enforceability of contractual liquidated damages provisions not otherwise expressly governed by statute. Each would apply in a specified class of cases:

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| (a) Presumed invalidity, rebuttable by a showing that it would be impracticable or extremely difficult to fix actual damages (consumer transactions). | 3
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| (b) Presumed invalidity, rebuttable by a showing of reasonableness (seller's liquidated damages provisions in residential realty purchase contracts in which the liquidated damages exceed 3% of the purchase price). | |
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| (c) Presumed validity, rebuttable by a showing of unreasonableness (commercial transactions; seller's liquidated damages provisions in non-residential realty purchase contracts and residential realty purchase contracts in which the liquidated damages are less than 3% of the purchase price; buyer's liquidated damages provisions in realty purchase contracts). | |
| <hr/> | |
| (d) Presumed validity, rebuttable by a showing of manifest unreasonableness (government public works construction contracts). | |

Thus, the thrust of the bill is, with respect to commercial transactions, to replace the existing presumption of invalidity with a presumption of validity.

3. The Law Revision Commission's recommendation relation to liquidated damages contains the following statement:

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

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desirable purposes, particularly including avoidance of the cost, the uncertainty, and the delay of litigating the issue of damages. 3
However, the limitations of existing law 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 sale or leasing of personal property or services to consumers or the sale or leasing of residential housing. 1
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IS NOT THE SAME REASONING APPLICABLE TO CONTRACTS BETWEEN LARGE CORPORATIONS AND SMALL BUSINESSES?

4. SB 1532 (1974) was introduced at the Commission's request to effectuate an earlier recommendation of the Commission on the subject of liquidated damages. However, the bill was never set for hearing because the Commission withdrew its recommendation after it concluded that the subject needed further study. This bill is the result of the Commission's further study.
 5. The bill prescribes rules to govern liquidated damages provisions in contracts for construction projects for the University of California. These rules are drawn from statutes relating to contracts for construction projects for other public entities.

A S S E M B L Y B I L L 3 1 6 9

(as passed by the Legislature)

and

O F F I C I A L C O M M E N T S

(including Comments from Senate Committee report)

[CONFORMING REVISIONS]

Civil Code § 1669 (technical addition)

Civil Code § 1670 (repealed)

TITLE 4.5. LIQUIDATED DAMAGES

CHAPTER 1. GENERAL PROVISIONS

Civil Code § 1671 (amended). General requirements for liquidated damages

Civil Code § 1676 (technical repeal)

CHAPTER 2. DEFAULT ON REAL PROPERTY PURCHASE CONTRACT

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

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

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

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

Civil Code § 1679 (added). Chapter applies only to liquidated damages for failure to purchase property

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

Civil Code § 1681 (added). Real property sales contracts excluded

[CONFORMING REVISIONS]

Civil Code § 1951.5 (technical amendment)

Civil Code § 3358 (technical amendment)

Education Code § 23190

Government Code § 14376 (amended). Contracts under State Contract Act

Government Code § 53069.85 (amended). Local public works contracts

Streets & Highways Code § 5254.5 (amended). Improvement Act of 1911

OPERATIVE DATE

APPLICATION TO EXISTING CONTRACTS

Civil Code § 1669 (technical addition)

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

[Law Revision Commission Comment]

Comment. Section 1669 continues without change former Section 1676.

Civil Code § 1670 (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.

[Law Revision Commission Comment]

Comment. Section 1670 is repealed but its substance is continued in subdivision (d) of Section 1671.

TITLE 4.5. LIQUIDATED DAMAGES

CHAPTER 1. GENERAL PROVISIONS

Civil Code § 1671 (amended). General requirements for liquidated damages

1671. (a) This section does not apply in any case where another statute expressly applicable to the contract prescribes the rules or standard for determining the validity of a provision in the contract liquidating the damages for the breach of the contract.

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

(c) The validity of a liquidated damages provision shall be determined under subdivision (d) and not under subdivision (b) where the liquidated damages are sought to be recovered from either:

(1) A party to a contract for the retail purchase, or rental, by such party of personal property or services, primarily for the party's personal, family, or household purposes; or

(2) A party to a lease of real property for use as a dwelling by the party or those dependent upon the party for support.

(d) In the cases described in subdivision (c), a provision in a contract liquidating damages for the breach of the contract is void except that the parties to such 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.

[Legislative Committee Comment--Senate]

Comment. Section 1671 is amended to provide in subdivision (b) a new general rule favoring the enforcement of liquidated damages provisions except against a consumer in a consumer case. In a consumer case, the prior law under former Sections 1670 and 1673, continued in subdivision (d), still applies.

Subdivision (a). Subdivision (a) makes clear that Section 1671 does not affect other statutes that govern liquidation of damages for breach of certain types of contracts. *E.g.*, Civil Code §§ 1675-1681 (default on contract to purchase real property); Com. Code § 2718 (sales transactions under the Commercial Code). 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-fainity, owner-occupied dwelling), 2982 (automobile sales finance); Educ. Code § 23190 (construction contracts for University of California); Fin. Code §§ 14852 (credit unions), 18667(a)(5) and 18934 (industrial loan companies), 22480(a)(2) (personal property brokers); Govt. Code §§ 14376 (state public works contracts), 53039.85 (contracts with cities, counties, and districts), 54348 (services of local agency enterprise); Sts. & Hwys. Code § 5254.5 (liquidated damages provision in contract under Improvement Act of 1911). These other statutes—not Section 1671—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 does apply. *E.g.*, Fin. Code §§ 18649 and 18669.2 (exceptions to Section 18667), 22053 (exception to Section 22480). Note that Section 1676, which provides a rule governing liquidated damages for the buyer's default on a contract for the sale of nonresidential real property, incorporates subdivision (b) of Section 1671.

It should be noted that Section 1671(a) does not apply where the validity of the liquidated damages provision is governed by federal law or a regulation adopted pursuant thereto. For example, the Federal Home Loan Bank Board has issued a regulation (Federal Register 5/3/76) which prescribes the maximum late payment charge that may be made with respect to home loans made after July 31, 1976, by federally chartered savings and loan associations.

Subdivision (b). Subdivision (b) provides that a reasonable liquidated damages provision is valid, but subdivision (d) rather than subdivision (b) applies where liquidated damages are sought to be recovered from the consumer in a consumer case. See subdivision (c).

In the cases where subdivision (b) applies, the burden of proof on the issue of reasonableness is on the party seeking to invalidate the liquidated damages provision. The subdivision limits the circumstances that may be taken into account in the determination of reasonableness to those in existence "at the time the contract was made." The validity of the liquidated damages provision depends upon its reasonableness at the time the contract was made and not as it appears in retrospect.

Accordingly, the amount of damages actually suffered has no bearing on the validity of the liquidated damages provision. Contrast Com. Code § 2718.

Unlike subdivision (d), subdivision (b) gives the parties considerable leeway in determining the 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 of 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.

Subdivision (c). Subdivision (c) makes the prior law under former Sections 1670 and 1671, continued in subdivision (d), applicable where liquidated damages are sought to be recovered from the consumer in a contract for the retail purchase, or rental, of personal property or services, primarily for personal, family, or household purposes, or for the lease of real property to be used as a dwelling by the party or persons dependant on the party for support. Of course, where the party seeking to avoid the liquidated damages provision is the nonconsumer party, subdivision (b) is applicable.

Subdivision (d). Subdivision (d) continues without substantive change the requirements of former Sections 1670 and 1671. The revision made in the former language of these sections is not intended to alter the substance of those sections as interpreted by the courts. For a discussion of the former law continued in subdivision (d), see Sweet, *Liquidated Damages in California*, 60 Cal. L. Rev. 81 (1972), reprinted in 11 Cal. L. Revision Comm'n Reports at 1229 (1973).

Deposits. 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. If the parties provide that the deposit shall be liquidated damages for a breach of the contract, the question whether the deposit may be retained in case of a breach is determined in accordance with the standard provided in subdivision (b) or subdivision (d), whichever applies. Contract Sections 1675-1681 ("earnest money" deposits). On the other hand, if the parties do not intend that the deposit shall constitute liquidated damages in the event of a breach, the deposit is merely a fund to secure the payment of actual damages if any are determined. 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).

Civil Code § 1676 (technical repeal)

1676.

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restraint of the marriage of any person, other than a minor, is void.

[Law Revision Commission Comment]

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

CHAPTER 2. DEFAULT ON REAL PROPERTY PURCHASE CONTRACT

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

1675. (a) As used in this section, "residential property" means real property primarily consisting of 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) To the extent that the amount paid does not exceed 3 percent of the purchase price, such amount is valid as liquidated damages unless the buyer establishes that such amount was unreasonable as liquidated damages under the circumstances existing at the time the contract was made. To the extent that the amount paid exceeds 3 percent of the purchase price, such excess amount is valid as liquidated damages only if the seller establishes that such excess amount was reasonable as liquidated damages under the circumstances existing at the time the contract was made.

[Legislative Committee Comment--Senate]

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 Section 1671. The liquidated damages provision is valid only if it is separately signed or initialed by the parties as required by Sections 1677 and 1678 and, if the contract is printed, the provision satisfies the type size requirements of Section 1677. The section does not apply to real property sales contracts as defined in Section 2935 (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 post-dated 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 Section 1671. 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 his "earnest money" deposit 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 for the failure to complete the purchase of the property. The subdivision provides a three-percent-of-purchase-price standard. If the amount paid is not in excess of three percent, the buyer has the burden of establishing that the liquidated damages provision was unreasonable "under the circumstances existing at the time the contract was made" in order to invalidate the liquidated damages provision. To the extent that the amount paid exceeds three percent of the purchase price, the seller has the burden of establishing that such additional amount 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 1671.

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 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.

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

1676. 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 Section 1677 and the requirements of subdivision (b) of Section 1671.

[Legislative Committee Comment--Senate]

Comment. Section 1676 applies the standard of subdivision (b) of Section 1671 to a liquidated damages provision for the buyer's default in a contract to purchase and sell real property other than residential property as defined in subdivision (a) of Section 1675. See Comment to Section 1671. Hence, if the applicable requirements of Section 1677 are satisfied, the liquidated damages provision is valid unless the buyer establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. See the discussion in the Comment to Section 1671 for an interpretation of this standard.

The liquidated damages provision is not valid unless it is separately signed or initialed by the parties and, if the contract is printed, the provision satisfies certain type-size requirements. See Section 1677.

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. Section 1676 does not, for example, apply to a provision liquidating damages if the seller fails to perform. Nor does the section affect the seller's right to obtain specific performance. See Section 1680. Section 1676 does not apply to real property sales contracts as defined in Section 2985. See Section 1681.

Where a liquidated damages provision is valid under this section, the limitations of Section 3367 (damages for breach of agreement to purchase real estate) do not apply.

**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) The provision is separately signed or initialed by each party to the contract; and
- (b) If the provision is included in a printed contract, it is set out either in at least 10-point bold type or in contrasting red print in at least eight-point bold type.

[Law Revision Commission Comment]

Comment. Section 1677 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 adapted from the 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 provide further assurance that the parties will be aware of the consequences of the liquidated damages provision. The provision for 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 provision, requiring at least 10-point bold 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).

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

1678. If more than one payment made by the buyer is to constitute liquidated damages under Section 1675, the amount of any payment after the first payment is valid as liquidated damages only if (1) the total of all such payments satisfies the requirements of Section 1675 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.

[Legislative Committee Comment--Senate]

Comment. Section 1678 is included to protect the buyer of residential property by requiring a separately signed or initialed agreement whenever 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. The payment made at the time the escrow is opened (or at some other time) 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. The standard provided by Section 1675 is applied to the total of all payments—the first and any subsequent payments—designated as liquidated damages by the contract.

Civil Code § 1679 (added). Chapter applies only to liquidated damages for failure 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.

[Law Revision Commission Comment]

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. Such damages are covered by Section 1671. Nor does the chapter affect the seller's right to obtain specific performance (see Section 1680).

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.

[Law Revision Commission Comment]

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 Section 3389, *People v. Ocean Shore R.R.*, 90 Cal. App.2d 464, 203 P.2d 579 (1949), and other cases interpreting Section 3389.

Civil Code § 1681 (added). Real property sales contracts excluded

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

[Law Revision Commission Comment]

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.

Civil Code § 1951.5 (technical amendment)

1951.5. Section 1671, relating to liquidated damages, applies to a lease of real property.

[Law Revision Commission Comment]

Comment. Section 1951.5 is amended to reflect the repeal of Section 1670. It should be noted that Section 1671 has been amended to change the rules governing the validity of liquidated damages provisions in certain cases. See Section 1671 and Comment.

Civil Code § 3358 (technical amendment)

3358. 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.

[Law Revision Commission Comment]

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 1671.

Article 7. Construction Contracts

23190. The Regents of the University of California may include or cause to be included in a contract for a construction project for the University of California a provision establishing the time within which the whole or any specified portion of the work contemplated shall be completed. The provision may provide that for each day completion is delayed beyond the specified time, the contractor shall forfeit and pay to the Regents of the University of California a specified sum of money, to be deducted from any payments due or to become due to the contractor. The sum so specified is valid as liquidated damages unless manifestly unreasonable under the circumstances existing at the time the contract was made. 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 and shall clearly set forth the basis for such payments. Nothing in this section restricts the authority of the Regents of the University of California to include any other provision concerning liquidated damages in any contract for a construction project.

[Legislative Committee Comment--Senate]

Comment. Section 23190 is added to provide a standard for determining the validity of a liquidated damages provision for late completion of a contract for a construction project for the University of California. Section 23190 is comparable to Government Code Sections 14376 and 53069.85 and Streets and Highways Code Section 5254.5. Civil Code Section 1671 does not apply to the liquidated damages provisions for late completion in contracts under Section 23190. See Civil Code § 1671(a) (general provisions not applicable where special statute provides standard for determining validity of liquidated damages provision). The last sentence of Section 23190 makes clear that the section does not restrict the authority of the Regents of the University of California to include any other provision concerning liquidated damages in a construction contract. Such other provisions are governed by Civil Code Section 1671.

Government Code § 14376 (amended). Contracts under State Contract Act

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. The sum so specified is valid as liquidated damages unless manifestly unreasonable under the circumstances existing at the time the contract was made. 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.

[Legislative Committee Comment--Senate]

Comment. Section 14370 is amended to provide a standard for determining the validity of a liquidated damages provision for late completion of a contract governed by this section. Prior to this amendment, the standard for determining the validity of such contract provisions was unclear. Civil Code Section 1671 does not apply to contracts under this section. See Civil Code § 1671(a) (general provisions not applicable where special statute provides standard for determining validity of liquidated damages provision).

Government Code § 53069.85 (amended). Local public works contracts

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. The sum so specified is valid as liquidated damages unless manifestly unreasonable under the circumstances existing at the time the contract was made. 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.

[Legislative Committee Comment--Senate]

Comment. Section 53069.85 is amended to provide a standard for determining the validity of a liquidated damages provision for late completion of a contract governed by this section. Prior to this amendment, the standard for determining the validity of such contract provisions was unclear. Civil Code Section 1671 does not apply to contracts under this section. See Civil Code § 1671(a) (general provisions not applicable where special statute provides standard for determining validity of liquidated damages provision).

Streets & Highways Code § 5254.5 (amended). Improvement Act of 1911

5254.5. At any time prior to publication and posting notice inviting bids, the legislative body by resolution,

may determine that in the event that the contractor, contracting owners included, does not complete the work within the time limit specified in the contract or within such further time as the legislative body shall have authorized, the contractor or contracting owners, as the case may be, shall pay to the city liquidated damages in the amount fixed by the legislative body in said resolution. The amount so fixed is valid as liquidated damages unless manifestly unreasonable under the circumstances existing at the time the contract was made. If such determination is made, the plans or specifications and the contract shall contain provisions in accordance therewith.

Any moneys received by the city on account of such liquidated damages shall be applied as follows:

(1) If received prior to confirmation of the assessment, such moneys shall be applied as a contribution against the assessment.

(2) If received after the confirmation of the assessment, such moneys shall be applied in the manner provided in Section 5132.1 for the disposition of excess acquisition funds.

(3) If a contribution has theretofore been made or ordered by any agency, the legislative body may order a refund to the contributing agency in the proportion which said contribution bears to the total costs and expenses of the work.

[Legislative Committee Comment--Senate]

Comment. Section 5254.5 is amended to provide a standard for determining the validity of a liquidated damages provision for late completion of a contract under this section. Prior to this amendment, the standard for determining the validity of such contract provisions was unclear. Civil Code Section 1671 does not apply to contracts under this section. See Civil Code § 1671(a) (general provisions not applicable where special statute provides standard for determining validity of liquidated damages provision).

Operative Date

This act shall become 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.

Application to existing contracts

This act applies only to contracts made on or after July 1, 1977.