

## Memorandum 72-71

Subject: Study 72 - Liquidated Damages

Attached are two copies of a tentative recommendation relating to liquidated damages. Please mark your suggested editorial changes on one copy and return it to the staff at the meeting so your suggestions can be taken into account when the next draft is prepared. We hope that you will be able to make suggestions that will improve the first portion of the tentative recommendation which attempts to state the "useful and legitimate" purposes that a liquidated damages provision serves.

With respect to the proposed legislation, the following matters are noted for your attention:

Section 3319 (pages 8-11)

This section states the general rule concerning liquidated damages clauses. The Comment attempts to state the intended effect of the section.

Section 3320 (pages 12-13)

This section provides the general rule concerning late payment charges. The section is based on existing statutes. See Exhibit I. See also Exhibit II reporting the conclusions of a committee of state utility regulators that the late payment charge assessed by utilities as "clearly . . . too high."

Section 2954.6 (page 8)

This section provides a special late payment charge rule for payments on loans secured by real estate. In connection with this section, you will need to examine Civil Code Section 2954.5 which is set out as Exhibit III.

See also the last item in Exhibit I (Crocker National Bank--Disclosure Statement Form for Real Estate Loan).

Section 3321 (page 14)

This section permits the parties to a real estate sale contract to agree that the "earnest money" deposit is liquidated damages. The two-percent standard appears to the staff to be reasonable, but we believe that this is a matter on which comments from interested persons and organizations will be helpful in evaluating.

Application to existing contracts

Section 9 on page 15 makes the act applicable to existing contracts. This will validate any liquidated damages provisions that are included in existing contracts even though there is a question concerning their validity under existing law. The section also provides that any provision of an existing contract that is valid under existing law is not made invalid by the enactment of the statute.

Respectfully submitted,

John H. DeMouilly  
Executive Secretary

LATE PAYMENT CHARGE PROVISIONS

Financial Code § 14803 (credit union)

§ 14832. Maximum fine

No credit union shall impose fines in case of failure of members to make payments on shares, loans or other accounts when due, in excess of \* \* \* 20 percent of interest due with a minimum of not less than five cents (\$0.05). Such fine may be made only once for each delinquent payment and may not exceed five dollars (\$5). (Amended by Stats.1970, c. 1114, p. 1983, § 8.)

Financial Code § 22480 (personal property brokers)

(5) In the event of default of more than 10 days in the payment of one-half or more of any scheduled installment, the licensee may charge and collect a default charge not exceeding an amount equal to the portion of the precomputed charge applicable to the final installment period. Said charge may not be collected more than once for the same default and may be collected at the time of such default or at any time thereafter. If such default charge is deducted from any payment received after default occurs, and such deduction results in the default of a subsequent installment, no charge may be made for the resulting default.

Financial Code § 18934 (insurance premium financing)

A premium finance agreement may provide for the payment of a default charge of one dollar (\$1) to a maximum of 5 percent of the delinquent installment but not to exceed five dollars (\$5), in the event of a default for a period of not less than 10 days in the payment of any scheduled installment under the terms of a premium finance agreement. Said charge may not be collected more than once for the same default and may be collected at the time of such default or at any time thereafter. If such default charge is deducted from any payment received after default occurs, and such deduction results in the default of a subsequent installment, no charge may be made for the resulting default. (Added Stats.1965, c. 1620, p. 3724, § 4, as amended Stats.1967, c. 351, p. —, § 1.)

**Civil Code § 1803.6 (retail installment sales)**

A contract may provide for the payment by the buyer of a delinquency charge on each installment in default for a period of not less than 10 days in an amount not in excess of 5 percent of such installment or five dollars (\$5), whichever is less, but a minimum charge of one dollar (\$1) may be made. Only one such delinquency charge may be collected on any such installment regardless of the period during which it remains in default. The contract may also provide for payment of any actual and reasonable costs of collection occasioned by removal of the goods from the State without written permission of the holder, or by the failure of the buyer to notify the holder of any change of residence, or by the failure of the buyer to communicate with the holder for a period of 45 days after any default in making payments due under the contract.

(Added by Stats.1959, c. 201, p. 2096, § 1.)

**Civil Code § 2982 (automobile conditional sales)**

(c) Finance charge; delinquency charge; collection costs and fees.

(c) The amount of the finance charge in any conditional sale contract for the sale of a motor vehicle, with or without accessories, shall not exceed 1 percent of the unpaid balance multiplied by the number of months (computed on the basis of a full month for any fractional month period in excess of 15 days) elapsing between the date of the contract and the due date of the last installment, or twenty-five dollars (\$25), whichever is greater. The contract may provide for a delinquency charge or charges on any installment in default for a period of not less than 10 days in an amount not to exceed in the aggregate 5 percent of the installment, which amount may be collected only once on any installment regardless of the period during which it remains in default. The contract may provide for reasonable collection costs and fees in the event of delinquency.

**CROCKER NATIONAL BANK (real estate loans) (Disclosure Statement Form)**

8. LATE PAYMENT CHARGE. On payments not paid within 15 days after the due date (subject to any notice required by law) a late charge equal to the lesser of such maximum amount, if any, as may be hereafter established by law, or the amount as indicated by mark below, is payable per dollar overdue:

- ☐ Conventional Loan — 4¢  
☐ FHA Loan — 2¢  
☐ VA Loan — 4%

Article published Tuesday October 24, 1972

# Late Payment Fees 'Too High'

WASHINGTON (UPI) —A penalty be extended from the present average of 15 days to 25 days, regulators said Monday that the late payment charge assessed by utilities against a customer actually is an interest charge that "clearly ... is too high."

In a 54-page report, the Committee on Utility Billing Practices of the National Association of Regulatory Utility Commissioners recommended that billings state the amount and annual rate of the interest.

The committee said, for example, a late payment charge of 98 cents, assessed against a customer who does not pay his monthly bill of \$14.02 in 15 days, amounts to 83.9 per cent annual interest.

"Clearly the current average level of effective annual rates for credit is too high," the committee said.

The group recommended that the time within which customers would be permitted to pay their bills without

garding billing. It said all utilities should state clearly on customer bills the date of the billing, the amount of the bill, the date the bill is due, the credit charge in dollars if the bill is not paid by the due date, and the effective annual rate of interest if the bill is not paid by then.

"Quite clearly periods of 15 days are too brief," it said.

The report found that 71 per cent of the states allowed the use of penalties or discounts by utilities. The more popular form of billing was net-gross discount billing.

Under this form of billing, for instance, a customer might have a net bill of \$14.02. If he pays within 15 days. Otherwise, he would have to pay the gross bill of \$15.

The 1968 Truth in Lending Act specifically exempted utilities from the requirement that businesses include the dollar amount as well as the annual interest rate of carrying charges.

The committee reported to the association, now in convention in New Orleans that all state regulators adopt a "full disclosure" policy re-

Civil Code Section 2954.5

**§ 2954.5 Delinquent payment charge; prerequisites to imposition**

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

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

(b) If a subsequent payment becomes delinquent the borrower shall be notified in writing, before the late charge is to be imposed, that the charge will be imposed if payment is not received, or the borrower shall be notified at 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 shall only affect loans made on and after January 1, 1971.

(Added by Stats.1970, c. 1430, p. 2773, § 1. Amended by Stats.1971, c. 813, p. —, § 1.)

TENTATIVE  
RECOMMENDATION OF THE CALIFORNIA  
LAW REVISION COMMISSION  
relating to  
LIQUIDATED DAMAGES

BACKGROUND

The parties to a contract may agree on the amount or the manner of computation of damages recoverable for breach.<sup>1</sup> The general statutory provisions governing such a liquidated damages provision in California are Sections 1670 and 1671 of the Civil Code.<sup>2</sup> These sections permit the use of a liquidated damages provision only where the actual damages "would be impracticable or extremely difficult to fix." In addition, the courts have developed a second requirement that there must be a reasonable endeavor to estimate actual damages.<sup>3</sup> The judicial decisions interpreting and applying Sections 1670

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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, 90-91 (1972)(hereinafter referred to as "background study").

2. Sections 1670 and 1671, which were enacted in 1872 and have not since been amended, read:

1670. Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.

1671. The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

3. *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal.2d 174, 187, 253 P.2d 10, 15 (1953); *McCarthy v. Tally*, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956).

and 1671 provide inadequate guidance to contracting parties and severely limit the use of a liquidated damages provision.<sup>4</sup> Unlike the Civil Code sections which reflect a traditional hostility to liquidated damages provisions, recently enacted statutes such as Section 2718 of the Commercial Code<sup>5</sup> encourage the use of such provisions.<sup>6</sup>

A liquidated damages provision may serve useful and legitimate functions.<sup>7</sup> A party to a contract may seek to control his risk exposure for his own breach by use of a liquidated damages provision. Such control is especially important if he is engaged in a high risk enterprise. A party also may desire to specify the damages for his own breach because he is unwilling to rely on the judicial process to determine the amount of damages. He may, for example, be fearful that the court will give insufficient consideration to legitimate excuses for nonperformance, that the court may be unduly sympathetic to the claim of the opposing party that all his losses should be paid by the breaching party, or that the court may manifest prejudice against contract breach to the extent of assessing damages on a punitive basis.

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4. See background study.

5. The pertinent portion of Section 2718 provides:

2718. (1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

6. For provisions authorizing liquidated damages in marketing contracts, see Agri. Code § 54264; Corp. Code § 13353. For provisions authorizing late payment charges, see, e.g., Civil Code §§ 1803.6 (retail installment sales), 2982 (automobile sales finance act); Fin. Code §§ 14852 (credit union), 18934 (insurance premium financing), 22480 (personal property brokers).

7. The following discussion draws heavily upon the background study. See background study at 86-87.



A nonbreaching party may use a liquidated damages provision because on occasion a breach will cause damage, the amount of which cannot be proved under damage rules. He may fear that, without an enforceable provision liquidating the damages, the other party will lack incentive to perform since any damages he causes will not be sufficiently provable to be collected. There is also a danger that, without a liquidated damages provision, the breaching party may recover the full contract price because the losses are not provable. A reasonable liquidated damages provision--one that is not disproportionate to actual, albeit unprovable, damages or to the contract price--is a good method of dealing with these problems.

Liquidated damages provisions may also be used to improve upon what the parties believe to be a deficiency in the litigation process--the cost and difficulty of judicially proving damages. Through a liquidation provision, the parties attempt by contract to settle the amount of damages involved and thus improve the normal rules of damages. Also, when the provision is phrased in such a way as to indicate that the breaching party will pay a specified amount if a particular breach occurs, troublesome problems involved in proving causation and foreseeability may be avoided. Finally, the parties may feel that, if they truly agree on damages in advance, it is unlikely that either would later dispute the amount of damages recoverable as a result of breach.

Use of liquidated damages provisions in appropriate cases also may improve judicial administration. Enforcement of liquidated damages provisions will encourage greater use of such provisions; will result in fewer breaches, fewer law suits, and fewer or easier trials, and in many cases will provide at least as just a result as a court trial.

While liquidated damages provisions may serve these and other useful and legitimate functions, there are dangers inherent in their use. There is the

risk that a liquidated damages provision will be used oppressively by a party able to dictate the terms of an agreement. And there is the risk that such a provision may be used unfairly against a party who does not fully appreciate the effect of the provision.

The Commission believes that the use of liquidated damages provisions is beneficial and should be encouraged, but the oppressive use of such provisions should not be permitted.

#### RECOMMENDATIONS

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

##### General Principles Governing Liquidated Damages

Sections 1670 and 1671 of the Civil Code should be replaced by a statute that applies to liquidated damages provisions in contracts generally (absent a specific statute that applies to the particular type of contract) and that implements the following basic principles:

(1) A contractual stipulation of damages should be valid unless found to be "manifestly unreasonable." This rule would reverse the basic disapproval of such provisions expressed in Sections 1670 and 1671 and in the judicial decisions while enabling courts to scrutinize such provisions in situations where they may be oppressive.

(2) Unreasonableness should be determined as of the time of the making of the contract rather than at the time of the trial. Consideration of the damages actually suffered should not be permitted. 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. Also,

consideration of actual damages would defeat one of the purposes of liquidated damages, which is to avoid litigation on the amount of actual damages.

(3) The party seeking to invalidate a liquidated damages provision should have the burden of pleading and proving that it is unreasonable. If the party seeking to rely on the provision were required to prove its reasonableness, he would lose one of the significant benefits of the use of liquidated damages, which is to simplify any litigation that may arise out of a breach of the contract.

#### Real Property Leases

The concurrent resolution directing the Law Revision Commission to study liquidated damages referred specifically to the use of liquidated damages provisions in real property leases. The Commission has concluded that no special rules applying to real property leases are necessary; the general rules recommended above will deal adequately with any liquidated damages problems in connection with such leases.

#### Land Sale Deposits

It is uncertain under existing law whether the parties to a sale of real property can agree that an "earnest money" deposit constitutes liquidated damages if the purchaser fails to complete the sale.<sup>8</sup> The general rules recommended above should apply to an "earnest money" deposit; and, in addition, to avoid uncertainty, a section should be enacted to provide that an "earnest money" deposit intended as liquidated damages is valid if it does not exceed two percent of the purchase price of the property. This section should not, however, preclude the parties from agreeing on a deposit of a

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8. See background study: Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 95-100 (1972).

larger amount as liquidated damages if such amount satisfies the rules for liquidated damages generally.

#### Late Payment Charges

A late payment charge in a contract requiring installment payments is a type of liquidated damages provision.<sup>9</sup> There are numerous statutes that prescribe the amount that may be imposed as a late payment charge under particular types of contracts.<sup>10</sup> No change is recommended in these provisions. However, to avoid uncertainty and to protect against oppression, a section should be enacted to prescribe the amount of a late payment charge that will be permitted in those contracts not now covered by statute. Specifically, a late payment charge for failure to pay an installment within 10 days from the time it was due should be permitted if the amount of the charge does not exceed five percent of the delinquent installment or five dollars, whichever is less; but a minimum charge of one dollar should be permitted. This restriction is the same in substance as those imposed by existing statutes regulating late payment charges. No greater late payment charge should be permitted unless two or more of the installments are at least \$250 and the general rules governing liquidated damages are satisfied.

A special rule should govern the late payment charge in case of a loan secured by real property. The maximum amount of such a charge should not exceed four percent of the delinquent payment.<sup>11</sup>

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9. *Cleremont v. Secured Investment Corp.*, 25 Cal. App.3d 766, Cal. Rptr. (1972).

10. See statutes cited in note 6 supra.

11. For a provision governing various aspects of the delinquent payment charge on a loan secured by real property (other than the amount of the late payment charge), see Civil Code § 2954.5.

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PROPOSED LEGISLATION

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

An act to amend Sections 1951.5 and 3358 of, to add Sections 2954.6, 3319, 3320, and 3321 to, and to repeal Sections 1670 and 1671 of, the Civil Code, relating to liquidation of damages.

The people of the State of California do enact as follows:

Section 1. Section 1670 of the Civil Code is repealed.

~~1670.--Every contract by which the amount of damage to be paid, or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.~~

Comment. Sections 1670 and 1671 are superseded by Section 3319. See also Sections 2954.6, 3320, and 3321.

Sec. 2. Section 1671 of the Civil Code is repealed.

~~1671.--The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.~~

Comment. See Comment to Section 1670.

Sec. 3. Section 1951.5 of the Civil Code is amended to read:

1951.5. ~~Sections 1670 and 1671~~ Section 3319 , relating to liquidated damages, ~~apply~~ applies to a lease of real property.

Comment. Sections 1670 and 1671 are superseded by Section 3319.

Sec. 4. Section 2954.6 is added to the Civil Code, to read:

2954.6. The amount of the default, delinquency, or late payment charge referred to in Section 2954.5 shall not exceed four percent of the delinquent installment. Such charge may not be collected more than once on the same delinquent installment regardless of the period during which it remains in default. If such charge is deducted from any payment received after the default occurs, and such deduction results in the default of a subsequent installment, no charge may be made for the resulting default.

Comment. Section 2954.6 specifies the maximum amount of late payment charge that may be made for a loan secured by real property described in Section 2954.5. A provision that imposes a late payment charge in an amount allowed by Section 2954.6 satisfies the requirements of Section 3319 of the Civil Code (liquidated damages provisions).

Sec. 5. Section 3319 is added to the Civil Code, to read:

3319. A provision in a contract liquidating the damages for breach of a contractual obligation is valid unless the party seeking to invalidate the provision establishes that it was manifestly unreasonable under the circumstances existing at the time of the making of the contract.

Comment. Section 3319, providing that a liquidated damages provision is valid unless proved manifestly unreasonable, reflects a policy that strongly favors the use of such provisions. See Recommendation and Study Relating to Liquidated Damages, 11 Cal. L. Revision Comm'n Reports 000 (1973).

Section 3319 limits the circumstances that may be taken into account in the determination of reasonableness to those existing "at the time of the making of the contract." Accordingly, the amount of damages actually suffered has no bearing on the validity of the liquidated damages provision. The validity of the provision depends upon its reasonableness at the time the contract was made. To permit consideration of the damages actually suffered would defeat one of the legitimate purposes of the clause which is to avoid litigation on the damages issue. Contrast Commercial Code Section 2718 which permits consideration of the "actual harm caused by the breach."

Relevant considerations in the determination whether the amount of liquidated damages is so high or so low as to be "manifestly unreasonable" include but are not limited to such matters as the relative equality of the bargaining power of the parties, the anticipation of the parties that proof of actual damages would be costly or inconvenient, the range of damages that reasonably would have been anticipated by the parties, and whether the liquidated damages provision is included in a form contract provided by one party. Thus, for example, there is little likelihood that a specially drafted liquidated damages provision in a contract executed by informed parties represented by attorneys after proper negotiation would be held invalid under Section 3319. On the other hand, Section 3319 requires that an unconscionable liquidation of damages provision in a form contract prepared

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by a party having a greatly superior bargaining position be held invalid.

To further implement the policy favoring liquidated damages provisions, Section 3319 places on the party seeking to avoid the provision the burden of pleading and proving that the liquidated damages provision is invalid. To require the party seeking to rely on the clause to plead and prove its reasonableness would destroy one of the significant benefits of the clause.

Section 3319 supersedes former Civil Code Sections 1670 and 1671. Section 1671 permitted liquidated damages only where the actual damages "would be impractical or extremely difficult to fix." This ambiguous limitation failed to provide guidance to the contracting parties and unduly limited the use of liquidated damages provisions. In addition, the courts developed a second requirement under Sections 1670 and 1671--that there be a reasonable endeavor to estimate actual damages. See Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal.2d 174, 187, 253 P.2d 10, 15 (1953); McCarthy v. Tally, 46 Cal.2d 577, 584, 297 P.2d 981, 986 (1956). Section 3319 does not limit the use of liquidated damages provisions to cases where damages would be difficult to fix or where it is likely that the amount selected by the parties is an accurate estimate of actual damages as a court could make. Instead, the parties are given considerable leeway to determine damages for breach. All the circumstances existing at the time of the making of the contract are considered, including but not limited to the relationship the damages provided bear to the range of harm that reasonably could be anticipated at the time of the making of the contract.

Instead of promising to pay a fixed sum as liquidated damages in case of a breach, a party to a contract may provide a deposit as security for the performance of his contractual obligations, to be forfeited in case of a breach.



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If the parties intend that the deposit be liquidated damages for breach of a contractual obligation, the question whether the deposit may be retained in case of breach is determined just as if the amount deposited were promised instead of deposited, and the standard provided in Section 3319 controls this determination. On the other hand, the deposit may be nothing more than a fund to secure the payment of actual damages if any are recovered; and, in such case, the deposit is not considered as liquidated damages. See Section 1951 (payment or deposit to secure performance of rental agreement). Compare Section 1951.5 (liquidation of damages authorized in real property lease).

Section 3319 does not, of course, affect the statutes that govern liquidation of damages for breach of certain types of contracts. E.g., Com. Code § 2718. See also Civil Code Section 3320 which prescribes the amount of a late payment charge that may be imposed under the contracts to which that section applies. For other late payment charge provisions, see, e.g. Civil Code Sections 1803.6 (retail installment sales), 2982 (automobile sales finance act); Financial Code Sections 14852 (credit union), 18934 (insurance premium financing), 22480 (personal property brokers). These other statutes--not Section 3319--govern the situations to which they apply. Compare Section 3321, which establishes an amount of earnest money deposit that is deemed to satisfy Section 3319 but does not preclude the parties from providing for a different amount of deposit if such amount satisfies the requirements of Section 3319.

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

3320. (a) Subject to any other provisions of law, the parties to a contract which requires periodic payments of money by one party to the other may provide for a late payment charge to be imposed as liquidated damages for the failure to make a payment within 10 days from the time the payment is due. Except as otherwise provided by law, a late payment charge shall be deemed to be reasonable and to satisfy the requirements of Section 3319 if the amount of the charge does not exceed five percent of the delinquent installment or five dollars (\$5), whichever is less, but a minimum charge of one dollar (\$1) may be made. Such charge may not be collected more than once for the same default. If such charge is deducted from any payment received after default, and such deduction results in the default of a subsequent installment, no charge may be made for the resulting default.

(b) Nothing in this section precludes the parties to a contract which requires more than one periodic payment of not less than \$250 from providing a specified late payment charge as liquidated damages if such provision satisfies the requirements of Section 3319 and all other applicable provisions of law.

(c) This section does not apply to any contracts to which the Commercial Code applies.

Comment. Section 3320 prescribes a late payment charge that satisfies the requirements of Section 3319. The charge permitted by Section 3320 does not apply where the amount of a late payment charge is prescribed by another statute. E.g., Civil Code §§ 1803.6 (retail installment sales), 2954.6 (real estate loans), 2982 (automobile conditional sales); Fin. Code §§ 14803 (credit union), 18934 (insurance premium financing), 22480 (personal property brokers).

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Under prior law, a late payment charge was held to be an attempt to liquidate damages but the validity of such charge as liquidated damages was uncertain. Cleremont v. Secured Investment Corp., 25 Cal. App.2d 766, \_\_\_ Cal. Rptr. \_\_\_ (1972). Section 3320 is included to avoid disputes as to the reasonableness of the amount of a late payment charge that does not exceed the amount specified in the section.

Section 3320 does not relieve the parties from complying with any applicable law which prescribes requirements governing such matters as notice of delinquency or manner of execution of the agreement. Subdivision (b) permits the parties to a contract which requires periodic payments of \$250 or more to provide for a late payment charge in an amount greater than prescribed in Section 3320. Subdivision (c) makes clear that Section 3320 does not apply to any contract to which the Commercial Code applies; the amount of a late payment charge which may be imposed pursuant to a contract to which the Commercial Code applies is to be determined pursuant to that code.

Sec. 7. Section 3321 is added to the Civil Code, to read:

3321. (a) Subject to Section 3319, the parties to a contract for the sale of real property may provide by a clause separately signed or initialed by each party that the deposit made by the purchaser at or before the time he executes the contract shall constitute liquidated damages to the vendor if the purchaser fails to proceed with the purchase.

(b) For the purposes of subdivision (a), a deposit shall be deemed to be reasonable and to satisfy the requirements of Section 3319 if the amount of the deposit does not exceed two percent of the total purchase price in the contract. Nothing in this subdivision precludes the parties from agreeing on a greater amount as liquidated damages than the amount specified in this subdivision if such agreement satisfies the requirements of subdivision (a).

Comment. Section 3321 makes clear that the parties to a contract to purchase land may agree that the deposit ("earnest money") made at the time the contract is made constitutes liquidated damages if the buyer defaults. Such a provision is valid unless the amount of the deposit is "manifestly unreasonable." See Section 3319. Under prior law, the validity of the use of a deposit as liquidated damages was uncertain. See Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 95-100 (1972), reprinted in 11 Cal. L. Revision Comm'n Reports 000-000 (1973). Subdivision (b) is included to avoid disputes as to the reasonableness of the amount of a deposit that does not exceed the two-percent limitation. The subdivision does not preclude the parties from providing that a larger deposit constitutes liquidated damages if the requirements of subdivision (a) and Section 3319 are satisfied.

Sec. 8. Section 3358 of the Civil Code is amended to read:

3358. Notwithstanding the provisions of this Chapter, 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, 3320, 3321, 3339, and 3340.

Sec. 9. This act applies to contracts executed before as well as those executed after its effective date but nothing in this act invalidates any provision in a contract executed prior to the effective date of this act if such provision is valid on the day prior to the day this act takes effect.