

## Memorandum 74-63

Subject: Study 72 - Liquidated Damages

This memorandum discusses policy alternatives for revising the recommendation on liquidated damages. At the May meeting, the Commission withdrew its support of Senate Bill 1532 which appeared to have no chance of passage. (A copy of the recommendation is attached.) Senate Bill 1532 was opposed by the State Bar, California Rural Legal Assistance, the Western Center on Law and Poverty, and the Association of Federated Consumers; other groups were studying the bill with a view to opposing it, but the bill was dropped before they completed their study. The bill was actively supported by the California Real Estate Association and was not opposed by the banks and savings and loan associations.

If the Commission does not want to permanently drop this topic, the following alternatives should be considered.

General Liquidated Damages Provision--Section 3319

Section 3319 of the printed recommendation reverses the presumption of existing Civil Code Sections 1670 and 1671 against liquidated damages, making liquidated damages provisions valid unless the party seeking to invalidate the provision establishes that it was unreasonable under the circumstances existing at the time of the making of the contract. This aspect of the recommendation has been opposed particularly because it would allow the imposition of "unreasonable" liquidated damages against consumers (since reasonableness would be judged at the time of contracting) and would require them to prove unreasonableness, which task in most cases consumers are unable or unwilling to undertake.

Consequently, the staff recommends serious consideration of the scheme provided in the Commercial Code, which allows consideration of actual damages and leaves the burden on the party seeking to enforce the provision. Commercial Code Section 2718 provides, in relevant part:

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 or 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.

(Professor Sweet, our consultant on this topic, recommended this in substance; he has redrafted this provision--see p. 1291 of the printed report.)

If the approach of the Commercial Code is adopted, there would be no real difference between standards applicable to commercial sales contracts and contracts generally. Allowing the court to consider actual damages in determining reasonableness would satisfy a major objection of consumer-oriented groups. Leaving the burden of proof on the party seeking to enforce the liquidated damages provision would also be favored by consumer and poverty groups. Obviously, in most consumer cases, to require the consumer to prove the unreasonableness of the liquidated damages, even as measured by actual damages, is to give the consumer a useless remedy.

Despite the Commission's strong views on the merits of its original proposal, it is obvious it has no chance for legislative approval. Accordingly, the staff recommends that we adopt the Commercial Code standard.

#### Late Payment Charges--Section 2954.6

The 10-percent late payment charge allowed by Section 2954.6 has also met with significant resistance. As presently drafted, Section 2954.6 is clearly legislatively unacceptable. The Commission should consider three alternatives:

(1) Late payment charges on loans secured by real property could be governed by existing law--Civil Code Sections 1670 and 1671 as applied by the courts. As the Commission will recall, in Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, 9 Cal.3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973), the California Supreme Court held that

a late charge on an installment payment on a loan secured by real property amounting to two percent per annum for the period of delinquency assessed against the unpaid principal balance is invalid as a penalty under Civil Code Sections 1670 and 1671.

The validity of late payment charges could be left to further judicial development under these sections.

(2) A provision like Commercial Code Section 2718 discussed above could be applied to late payment charges. The result would probably not be too much different from that under existing statutes as applied in Garrett, depending on how rigorously the courts would apply the actual damages test and the difficulty of proof of damages test.

(3) The framework of Section 2954.6 could be recommended, but with a lower percentage ceiling than 10 percent for loans where the monthly payment is under \$500. The staff believes that a 5-percent ceiling (with a minimum of \$5 or 20 percent of payments under \$50, whichever is less) is reasonable and fair. The cost of the unpaid installment to the lender is not more than 1-1/2 percent per month; the administrative costs should not be more than a few dollars. By way of comparison delinquency charges under the Unruh Act (Civil Code Section 1803.6) may not exceed 5 percent of the installment or \$5, whichever is less, with a minimum charge of \$1. But under the Unruh Act, the charge may be made only once, whereas under the Commission's Section 2954.6, the late payment charge, if unpaid, may be added to principal--a provision more favorable to lenders.

#### Earnest Money Deposits--Section 3320

The feature of Section 3320 which makes valid as liquidated damages a 5-percent earnest money deposit in contracts for the sale of real property also met serious opposition. This opposition was further

strengthened when the bill was amended at the instigation of the California Real Estate Association to provide that such "deposits" need not be actually deposited, but only "clearly indicated."

The Commission should consider eliminating the 5 percent provision and leaving liquidated damages in contracts for the sale of real property to the general liquidated damages provision. This would avoid the existing uncertainty whether such an earnest money deposit can be made liquidated damages under Civil Code Sections 1670 and 1671 but would not require the courts to uphold an unreasonable liquidated damages clause.

Respectfully submitted,

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