#72 9/25/75

First Supplement to Memorandum 75-61

Subject: Study 72 - Liquidated Damages

Attached as Exhibit I is a letter from Richard D. Agay, an attorney who has long been interested in our efforts to reform the law relating to liquidated damages. His comments are directed to the staff draft attached to Memorandum 75-61. The following is an analysis of the points he makes in his letter.

Use of Commission Comments

Mr. Agay believes some material in the Comments should be included in the text of the statute. He is concerned that courts will not consider the Comments authoritative, especially where the bill is amended after its introduction. I have written to Mr. Agay and pointed out that the legislative committees adopt special reports to revise the Comments to reflect amendments after the bill is introduced and to deal with other matters that come up at the legislative hearings. Specific suggestions of Mr. Agay as to material that he believes should be placed in the text of the statute are discussed below.

Meaning of "Substantially Inferior Bargaining Position"

Mr. Agay is concerned that the standard--"substantially inferior bargaining position"--is a vague one, especially in the absence of a form agreement. See his point 3 on pages 2 and 3 of his letter. He would substantially limit the circumstances where this defense could be raised. The staff believes that there is merit to his point, but we would not go as far as he suggests. Instead, we suggest that subdivision (b) of Section 1672 (page 9 of Staff Draft) be revised to read:

> . . . . unless the party seeking to invalidate the provision establishes any of the following:

(a) [excepts consumer transactions]

(b) ~~He~~ At the time the contract was made, he was not represented by a lawyer and was in a substantially inferior bargaining position ~~at the time the contract was made~~ .

(c) [reasonableness requirement]

We believe that the above revision--to limit the inferior bargaining position defense to parties not represented by counsel--is highly desirable and will conform the substance of the statute to what the Commission has had in mind in drafting its recommendations on liquidated damages. The Commission also should give careful consideration to the other suggestions of Mr. Agay which would further tighten up the exceptions to Section 1672.

Standard for Determining Reasonableness

Subdivision (c) of Section 1672 (page 9 Staff Draft) makes a liquidated damages provision invalid if it was unreasonable under the circumstances existing at the time the contract was made. Mr. Agay suggests that there be a listing in the statute of the appropriate factors which would make the provision unreasonable. The Commission previously decided to include such a listing of some of the factors in the Comment. In May 1973, Mr. Agay suggested the following be included in the statute:

> No provision shall be considered unreasonable unless it is established at the time of the making of the contract either (1) the maximum amount of all reasonably anticipated damages including nonrecoverable costs or expenses which might reasonably be incurred in order to prove such damages or to prove the right to recover damages, under all possible circumstances, was less than the amount liquidated in the contract, or (2) the amount of all reasonably anticipated damages under all circumstances would be easily and clearly determinable without under any circumstances the necessity of incurring nonrecoverable costs or expenses to prove such damages or the right to recover same.

Sections 1673 and 1674

Mr. Agay expresses concern about Sections 1673 and 1674 (pages 12-14 of Staff Draft). See his discussion under point 5 at pages 3 and 4 of his letter.

There is merit to his point that a liquidated damages provision should be void to the extent of the deposit (and to any greater extent that the provision satisfies the requirements of Section 1671 or 1672) where the contract does not relate to single-family residential property. We argue in the recommendation that the buyer of real property expects for forfeit his deposit if he does not go forward with the deal. Is this not also true in cases where the property purchased is other than a single-family residential unit?

We suggest that Section 1673 (pages 12 and 13 of the Staff Draft) be revised to read:

> 1673. (a) ~~Except as provided by Section 1674, a~~ A provision in a contract for the sale of real property liquidating the damages to the seller if the buyer fails to purchase the property is invalid unless it is separately signed or initialed by each party and satisfies the requirements of Section 1671 or, where the contract is one covered by Section 1672, the requirements of that section.
>
> (b) Notwithstanding subdivision (a), where the parties to a contract for the sale of real property provide that all or any part of a deposit made by the buyer shall constitute liquidated damages to the seller if the buyer fails to purchase the property, such amount is valid as liquidated damages to the extent that it is actually deposited in the form of cash or check (including a postdated check) unless the buyer establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. Nothing in this subdivision makes invalid a liquidated damages provision that is valid under subdivision (a).
>
> (c) This section does not apply to contracts described in Section 1674 or to real property sales contracts as defined in Section 2985.

The effect of this revision is that the actual deposit is valid liquidated damages in a real property purchase contract to the same extent as provided in Section 1674 (single-family residential unit) but, unlike Section 1674, a contract not under Section 1674 may liquidate the damages at a greater amount if the provision satisfies the requirements of subdivision (a) of Section 1673. We believe that this is a desirable revision for the reasons indicated in Mr. Agay's letter.

If the revisions suggested in this supplement are approved, the staff will present a revised recommendation for approval for printing at the November meeting.

Respectfully submitted,

John H. DeMoully
Executive Secretary

First Supp Memo 75-61 EXHIBIT I

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IN REPLY PLEASE REFER TO:

September 22, 1975 RDA - Law Revision

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

Re: November 1975 Staff Draft Proposed Resolution
Relating to Liquidated Damages

Gentlemen:

I have read the foregoing draft, as well as the superceded January 1975 draft. In connection therewith, I have the following comments and suggestions.

1. As I have indicated since my May 2, 1973 letter, I think that the efficiency sought by this legislation will be enhanced only if the standards defining either "reasonable" or "unreasonable" are more detailed or at least the factors defining such reasonableness or unreasonableness set forth within the legislation. Unless I have overlooked something, I have seen no comment within any of the minutes or other materials since my May 2nd letter (Memorandum 73-47, Exhibit XVII) which contradicts the position I there voiced, to wit: "It is unfair to burden not only the public but attorneys with the necessity of constantly referring to legislative history or comments of draftsmen in order to understand legislation. It is dangerous to rely upon the fact that trial judges will necessarily be familiar with comments or will interpret legislation according to such comments. It is particularly dangerous to rely upon the use of such comments to aid in interpreting legislation if the proposed legislation is in any way altered by the legislature prior to its adoption. Such change may or may not have been made with a view to altering the purposes set forth within comments of the draftsmen (in this case, the Law Revision Commission) the courts interpreting such changes can go either way in such interpretation. If, on the other hand, the comments were codified, or at least included within the proposed legislation, then any changes made by the legislature would be clear as to whether such materials were intended to be changed."

2. As I therefore have previously indicated, I feel that especially the element of the difficulty of proof and the expense incurred in presenting proof of damages should not only be codified but there should be a recitation that unless the party attacking the liquidated damages provision could show that under all circumstances damages would be easily calculable without substantial expense of proof, then the provision should be deemed reasonable.

3. I believe that subdivision (b) of Section 1672 goes beyond the thrust of most of the comments submitted to you. I, of course, am an advocate of the liquidated damages provisions. Even I, however, recognize that the liberalization had to stop at contracts of adhesion or form agreements prepared by a party having a greatly superior bargaining position. I do not believe, however, that it is proper to reverse the presumptions or the burden of proof merely because of a showing that one side was better equipped than another. The contract may well have been negotiated. The limitation should, I believe, be in terms of a triple standard so that unless all three elements are met, the presumption of reasonableness applies and validity applies. Those standards would be: (1) a form or standard agreement of one party substantially unaltered, (2) where no representation of counsel was had by the defaulting party and (3) where the defaulting party had no bargaining strenth at the time of negotiation.

a. The determination of inferiority of superiority in bargaining position may well be a very difficult question of proof, especially in the absence of form agreements. Secondly, there is no statement as to the quantum of inferiority needed to justify the application of Section 1672(b). Obviously, in many situations, one of the two parties will be in a substantially inferior position. Remember that in subdivision (a) you have removed the onus which would attach to the retail purchase of consumer goods so that we are not dealing with any of those types of situations to which many legislators would object.

b. There seems to be no justification for striking on otherwise reasonable liquidated damages clause (see subdivision (c) which would strike any provision which was unreasonable) where the defaulting party was represented by counsel. Under these circumstances, he went into the transaction with his eyes wide open (or at least should have had knowledge of the risks) and in any event, the party dealing with him certainly could rely upon the fact that the defaulting party should have known the risks involved where he was represented by counsel.

c. The necessity for including the condition of no bargaining strength is exemplified by the fact that many times form agreements are picked up in stationery stores where neither side has a superior bargaining position of any great magnitude. In such cases, there is no reason why the clause should be unenforceable.

4. It is with respect to subdivision (c) of Section 1672 where my comments above concern the listing of appropriate factors which would make the provision unreasonable ought to be included. Again, I refer back to my May 2, 1973 letter and especially to the second paragraph under Section 1319(b) on page 2 thereof. I do not purport that his is the last word in draftsmanship, but I think something of that nature ought to be substituted for the language included under subdivision (c) or at least added to that subdivision.

5. There is something peculiar about Sections 1673 and 1674 in the sense that in the non-residential purchase, the standards appear to be stricter. What justification can there be for that approach?

a. I reached the foregoing conclusion by noting under Section 1673 the standard applied is that under Sections 1671 and 1672. However, under 1674(b), a new standard is adopted for the sale of single family residences whereby the deposit can be the liquidated damages unless the buyer shows that the provision was unreasonable at the time the contract was made. While I applaud this liberalization as to residential purchases, I note that the requirements of Section 1672(b) are still in full force and effect as to a non-residential purchase. Thus, a showing of substantially inferior bargaining position on the part of the buyer will permit his avoidance of a liquidated damages clause if he is buying a multi-million dollar commercial building but not if he is buying a $30,000.00 home. The recognized expectation that buyers assume that their deposits will be forfeited is as applicable in commercial real estate as it is in residential real estate. The only difference might be that attorneys more frequently get involved in commercial real estate transactions and they know that the law does not equate deposits with damages.

b. In any event, I see no justification within any of the comments for making more difficult the enforcement of a liquidated damage clause in the purchase of single family residential real estate. I, therefore, think that Section 1674 should be changed to be 1673 and should eliminate the reference to

single family residences, but rather apply to all purchases of real estate (other than the land sale contract as covered under subdivision (c)).

I thank you in advance for the privilege of commenting upon the proposed legislation.

Sincerely yours,

RICHARD D. AGAY

(Dictated but not read)

RDA:kjs