

Memorandum 76-30

Subject: Study 72 - Liquidated Damages (Assembly Bill 3169)

This memorandum considers the comments we have received concerning the Recommendation Relating to Liquidated Damages (copy attached). With some reluctance, Assemblyman McAlister introduced the recommended legislation. See Assembly Bill 3169 attached. The following is a discussion of the comments concerning this bill.

Deposit on sale of residential property--five-percent rule

Staff recommendation: The staff recommends that the five-percent figure in subdivision (c) of Section 1675 be changed to two percent.

Section 1675 provides that, in a contract to purchase and sell residential property, a liquidated damages provision not exceeding five percent of the purchase price is valid unless the buyer establishes that the amount was unreasonable under the circumstances existing at the time the contract was made. Any amount exceeding five percent is valid only if the seller establishes that the excess is reasonable under the circumstances existing at the time the contract was made.

Assemblyman McAlister introduced the recommended legislation after giving it considerable thought. He said he was satisfied with the bill except that he thought the five-percent rule should be lowered to two percent. He agreed to introduce the bill in the form recommended by the Commission. It was understood, however, that he would state before the committee that it was his personal view that the five-percent figure was too high, and it should be two percent and that that was a matter for committee decision.

The Northern Section of the State Bar Committee on Administration of Justice (see Exhibit I) approved the Commission recommendation with two suggestions. One is that the five-percent figure in Section 1675 should be changed to two percent.

Deletion of subdivisions (b) and (c) of Section 1676

Staff recommendation: Retain these subdivisions.

The Northern Section of the State Bar Committee on Administration of Justice (Exhibit I) also recommended the deletion of subdivisions (b)

and (c) of Section 1676. According to the committee, these subdivisions are "confusing and unnecessary." While the staff agrees that these provisions are complex and difficult to understand on first reading, they have been drafted with great care and perform a necessary function. Section 1676 is the basic section determining the validity of liquidated damages provisions in contracts for the purchase and sale of nonresidential real property. (It should be noted that Exhibit A of the committee's comments incorrectly sets forth the last line of subdivision (a) of Section 1676. See Exhibit I to this memorandum. This may be in part responsible for the committee's conclusion.) Subdivisions (b) and (c) are necessary to achieve the policy of the recommendation. As subdivision (a) provides, a liquidated damages provision in a contract for the purchase and sale of nonresidential real property must satisfy the requirements of Sections 1677 and 1678 (concerning the signing or initialing of provisions) and the requirements of subdivision (b) or (c). Subdivision (b) permits the validation of the liquidated damages provision under the standards provided in Section 1671: (1) where the party from whom the damages are sought establishes that he was in a substantially inferior bargaining position or where a consumer contract is involved, the liquidated damages provision is void except where actual damages would be impracticable or extremely difficult to fix; (2) in other cases, the liquidated damages provision 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. Subdivision (c) of Section 1676 applies where the contract provides that an amount deposited is to be considered liquidated damages and makes such amount valid as liquidated damages to the extent that such amount is actually deposited in the form of cash or check unless the buyer establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. While this arrangement admittedly is rather complicated, it must be so in order to properly apply a set of possible standards to various types of contracts and situations.

Reasonable liquidated damages provision unenforceable against party in substantially inferior bargaining position

No staff recommendation.

The State Bar Committee (Exhibit I) discussion initially focused on subdivision (c)(1) of Section 1671 which makes the "reasonableness"

standard for upholding liquidated damages provisions inapplicable where one party is in an inferior bargaining position. The committee Minutes state: "It was noted that such provision creates a new and unnecessary issue to be litigation and that in some instances it would be difficult to determine who was in the inferior bargaining position, as in a dispute between two corporations. However, it was suggested that this provision would have infrequent application and that in instances of applicability the case would be clear, e.g., adhesion contracts." The assumption that this is limited to adhesion contracts seems contrary to the general tenor of the Commission's recommendation and the Comment to Section 1671. The State Bar Committee finally approved Section 1671 (four yes, two no) because of the past difficulty this recommendation has had in obtaining approval of the Board of Governors on the ground that liquidated damages clauses are detrimental to the "little people."

Mr. Jordan A. Dreifus, in Exhibit II attached, raises essentially the same point when he asks: "Where would the typical construction contract case fit under your proposed criteria in § 1671(c)? Would these be under subdivision (b) or subdivision (d)? Absent a clearer statement in subdivision (c), the matter would have to be settled by years of appellate litigation." It is probably true that litigation will be necessary to determine the precise meaning of subdivision (c)(1)--whether the provision is limited to adhesion contracts as the State Bar Committee apparently believes or whether it will be given a broader meaning. However, we do not believe that the appellate decisions will be very helpful in determining whether a particular construction contract falls under subdivision (b) or (d) because each case must be examined on its own facts in light of the situation of each party and the circumstances that existed when the contract was made. Although appellate decisions can be helpful in providing some guidelines, they will not avoid the need for the trial court to determine each case based on the facts and circumstances of that case. The staff has previously recommended the deletion of subdivision (c)(1) on the ground that it may permit a party to invalidate a reasonable liquidated damages provision in a nonconsumer case.

Public construction contracts

Staff recommendation: No change.

Mr. Jordan A. Dreifus (Exhibit II) argues that the Commission proposal might result in a substantial change in the law concerning public construction contracts--specifically, (1) that the exemption from the provisions of Section 1671 proposed to be added to the statutes providing for liquidated damages provisions in government contracts (Govt. Code §§ 14376 and 53069.85) does not accurately express current law and (2) that the proposed Section 1671 does not continue the important case law gloss on existing Section 1671 concerning "reasonableness of the forecast."

Taking the first point, Mr. Dreifus states that the provision of Government Code Section 14376 relating to inclusion of liquidated damages provisions in contracts under the State Contract Act (see page 6 of AB 3169, attached hereto) does not "amount to anything other than an expression that liquidated damage clauses in public construction contracts are not contrary to public policy and will be enforceable, assuming the remaining criteria for validity are met by the specific contract provision." The staff believes this provision carries more weight. In Silva & Hill Construction Co. v. Employers Mutual Liability Insurance Co., 19 Cal. App.3d 914, 97 Cal. Rptr. 493 (1971), the court held:

It is our conclusion that section 14376 of the Government Code is in effect a legislative determination that late charges imposed on a construction company by a state contract fall within the provisions of section 1671 of the Civil Code and as such are valid liquidated damages. This conclusion is compelled by the fact that section 14376 is a special statute enacted in response to unique circumstances. Thus, the character of the contracts to which section 14376 applies, the widespread use of liquidated damage provisions in such contracts, and the protection afforded the public by such provisions are factors which provide a reasonable basis on which the Legislature could properly take notice that the nature of state construction projects makes it "impracticable or extremely difficult to fix the actual damage" caused by a contractor's late completion of a state project.

The court in this case did not discuss any further requirements for holding the liquidated damages provision valid. The staff has not discovered any public contract case in California that applied a "reasonable forecast" or "reasonable endeavor to fix actual damages" test. Consequently, the staff believes that the proposed amendments to the

statutes dealing with public contracts adequately continues existing law as reflected in the Silva & Hill Construction Co. case. Under existing law, the effect of Government Code Section 14376 is to satisfy the requirement of Section 1671. Therefore, the prohibition against liquidated damages contained in Section 1670 does not apply. Although we believe that no further requirements must be met to enforce such liquidated damages provisions (ignoring any questions of responsibility for delay, excused delay, substantial completion, and the like), the Commission's proposal does not preclude courts from applying some sort of reasonableness standard.

Taking the second point, that the proposed amendment to Section 1671 does not continue the case law rules concerning "reasonableness of the forecast," four things should be said. First, the Comment to Section 1671 states:

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 these sections as interpreted by the courts.

Second, the rule in California is not that the liquidated damages provision must be a "reasonable forecast" but that the "liquidated damages clause must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation." Smith v. Royal Mfg. Co., 185 Cal. App.2d 315, 8 Cal. Rptr. 417 (1960); Better Food Mkts. v. Amer. Dist. Teleg. Co., 40 Cal.2d 179, 253 P.2d 10 (1953); Rice v. Schmid, 18 Cal.2d 382, 115 P.2d 498 (1941). Third, as indicated above, the California cases do not show that this requirement is applied to public construction contracts. The Commission's consultant on liquidated damages reports that "most such construction contract liquidation clauses would not pass muster as genuine attempts to estimate damages as required by section 1671" but they are usually enforced anyway.

There are a number of reasons for this. First, while the liquidation amounts may not actually be bargained, the contractor can take this into account when he makes his bid. Second, most construction contractors are not so unsophisticated as to merit special protection by the courts. Third, courts enforce these clauses as a means of saving themselves from having to decide difficult fact questions relating to damages. Finally, these clauses are enforced because delays do cause losses, but the actual loss is often not provable under traditional damage rules, which require certainty, proof of causation, and foreseeability. [See Exhibit III, p. 122.]

Several letters from public entities received in 1973 in response to the Commission's earlier liquidated damages recommendation freely admit that there is no attempt to estimate actual damages and that the purpose of the liquidated damages clause is to get the project done as quickly as possible to avoid the adverse consequences to the public of a delay in public works projects. Finally, it should be remembered that, under the Commission's proposal, most public contracts will fall under the Government Code provisions--not Section 1671.

Mr. Dreifus also asks what is the real difference between subdivisions (b) and (d) in light of the fact that subdivision (d) has a case law gloss. The difference is marked. Under subdivision (b), the party seeking to enforce the provision for liquidated damages is not required to make any showing; the burden is on the other party to show that the provision was unreasonable under the circumstances existing at the time of contracting. Under subdivision (d), the party seeking to enforce the provision has the burden of showing that, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damages and (under the cases) that the clause reflects a reasonable endeavor by the parties to fix a fair compensation for breach. Quite a few correspondents with the Commission would differ with Mr. Dreifus' statement that the language of Section 1671 has been "superseded."

Finally, Mr. Dreifus refers us to cases interpreting provisions in federal contracts as a more desirable alternative to the Commission's proposal. The staff notes that it is the Commission's intention to continue existing law regarding public contracts and to generally favor liquidated damages provisions (except in the cases of substantially inferior bargaining power and consumer cases, where old law is to continue). Proposals similar to the federal standard were considered earlier in the drafting of the previous recommendation as well as in the drafting of the current recommendation. The examples of federal regulations attached to Mr. Dreifus' letter are significantly more detailed than California statutory provisions concerning liquidated damages in public contracts. While the federal regulations may be highly desirable, the staff does not think that AB 3169 is the proper vehicle for codifying detailed regulations concerning liquidated damages in public contracts. The Commission has previously determined not to attempt to

deal specially with the complex area of government contracts. Any special provisions are best left to specialists who might design appropriate tables for calculation of liquidated damages for delay or set other limits like those in the federal regulations. We suspect that state agencies have developed a practice of relatively consistent liquidated damages provisions even if such practice is not reflected in the regulations or statutes. In any event, the regulations appended to Mr. Dreifus' letter reflect a different policy than the Commission's recommendation in that the federal regulations typically provide that the "rate of assessment of liquidated damages must be reasonable considered in the light of procurement requirements on a case-by-case basis, since liquidated damages fixed without reference to probable actual damages may be held to be a penalty and therefore unenforceable." (32 C.F.R. § 1.310) Furthermore, according to the Silva & Hill Construction Co. decision (quoted supra), the California Legislature has already made the policy determination by statute that the federal agency is required to make in each case under 41 C.F.R. § 1-1.315-2:

- (a) Liquidated damages provision may be used only where both
- (1) the time of delivery or performance is such an important factor in the award of the contract that the Government may reasonably expect to suffer damage if the delivery or performance is delinquent, and
 - (2) the extent or amount of such damage would be difficult or impossible of ascertainment or proof.

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT I

AGENDA 29.6 - LIQUIDATED DAMAGES

(2/5/76) 1002

ACTION TAKEN: Approve Law Revision Commission proposal except as set forth in Exhibit A.

DISCUSSION: Mr. Wulff reported orally on this Law Revision Commission proposal concerning liquidated damages. The proposal would repeal CC 1670 and amend CC 1671 to validate liquidated damages clauses in contracts, unless it was shown that at the time of contracting the provision was unreasonable. The validity of liquidated damages clauses in contracts for (1) consumer goods, or (2) where the party against whom the provision is to be enforced can show that (s)he was in a substantially inferior bargaining position, would be governed by the present test (e.g., such damages are reasonable and the measure of damages is extremely difficult to fix). There are also special provisions for contracts to sell residential property. The Section initially reviewed the proposed new CC 1671 and the discussion focused on subsection (c)(1) which invalidates liquidated damage provisions where one party is in an inferior bargaining position. It was noted that such provision creates a new and unnecessary issue to be litigated and that in some instances it would be difficult to determine who was in the inferior bargaining position, as in a dispute between two corporations. However, it was suggested that this provision would have infrequent application and that in instances of applicability the case would be clear, e.g., adhesion contracts. Also, it was noted that the proposal addresses the concern expressed by the Board of Governors that liquidated damages clauses are detrimental to the "little people", by incorporating these tests. Upon motion it was resolved to approve CC 1671 (4 yes, 2 no). The Section next considered the proposal for land sale contracts (CC 1675 et seq.). Discussion here included a concern whether condominiums are included in the definition of residential property and the amount allowed (5% of the purchase price) as liquidated damages. It was concluded that condominiums are included in the definition. The Section approved the remainder of the LRC proposal as follows: CC 1675(c)-reduce the maximum allowed liquidated damages from 5% to 2% of the sale price; CC 1676-strike subsections (b) and (c) as confusing and unnecessary. See Exhibit A for revised text. As a final note, the Section indicated that the reference in Streets & Highways Code §5254.5 on pages 24-25 of the LRC report re inapplicability of CC 1671 to §5254.5 was unnecessary in light of CC 1671(a) which states that CC 1671 is not applicable to other code sections containing specific liquidated damages provisions. This note is intended as a general comment and not as an objection.

EXHIBIT A

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 ~~five percent~~ two 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 ~~five percent~~ two percent of the purchase price, such excess

EXHIBIT A (continued)

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.

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

1676. (a) Except as provided in Section 1675, a provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to purchase the property is valid if it satisfies the requirements of Sections 1677 and 1678 ~~and the requirements of subsection (b) or (c) of Section 1671.~~

~~(b) The liquidated damages provision is valid if it satisfies the requirements of subdivisions (b) or (d) of Section 1671, whichever subdivision is applicable.~~

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

EXHIBIT II

SCHWARTZ & DREIFUS

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February 27, 1976

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Re: CLRC Recommendation re Liquidated Damages

Dear Mr. De Mouilly:

This letter follows my conversation with you of February 18, 1976 and my review of the liquidated damage recommendation which bears a date of February 13, 1976.

The nature of my practice and my experience has a bearing on my comments. We generally represent construction subcontractors and also, on occasion, prime contractors. This includes the representation of such parties in negotiation and/or litigation over liquidated damage provisions of governmental and non-governmental construction contracts.

My conclusions are:

(a) The Law Revision Commission proposal, in its present form, could be construed to be a substantial change in the law with respect to state and local public construction contracts; at least there is sufficient risk of this result in the proposed amendments to make such a substantial change plausibly arguable on the part of the government entities who would deem themselves advantaged by such a change. It would create otherwise unnecessary litigation, even if eventually held that no change was intended.

(b) It is not at all clear whether the typical liquidated damages for delay provision of a construction prime contract or subcontract is intended to fit within proposed Civil Code §1671(b) or proposed 1671(d).

(c) The amendments proposed for the several sections of the Government Code, albeit labeled "technical", could be construed as anything but technical. They could be construed to mean that the state and local government entities involved are thereby freed from the limitations upon arbitrary and unreasonable provisions which are now the case law.

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I will state the reasons for these conclusions. I regret that I do not have the time or opportunity to give you a more comprehensive discussion than that which follows. I have looked at the article by Professor Sweet referred to in the Commission's recommendation.

The typical fixed price advertised bid construction contract is the ultimate example of the contract of adhesion. Probably this is true generally because of the highly competitive nature of the market and the ease with which persons can enter the construction contracting business. They are usually undercapitalized; this insecurity created the rule in this country that payment and performance of construction usually is secured by mechanics' liens, surety bonds or other collateral.

In public works construction contracts, the advantage of the "owner" or "customer" in dealing with contractors is made a matter of law or regulation. It is my guess that this is a remnant of the 19th century view that public officials usually are part-time amateurs and contractors are clever full-time professionals, etc. This view is no longer true for most state and local agencies and is emphatically untrue especially since World War II with regard to the federal government. If this is the case (leaving aside for the moment the several Government Code and Streets and Highways Code provisions), where would the typical construction contract case fit under your proposed criteria in §1671(c)? Would these be under subdivision (b) or subdivision (d)? Absent a clearer statement in subdivision (c), the matter would have to be settled by years of appellate litigation.

The addition of the cross references to Government Code §14376 (and the other like provisions) which would exempt those public contract provisions from the coverage of new proposed §1671, in my opinion does not express what the law now is, would in fact be a substantial change in the law and would be just plain wrong. The reason is that new §1671, as proposed, would now contain the other major requirement (reasonableness of the forecast, etc.) which is not expressed in the 1872 version of §1671. I have not understood Government Code §14376 to amount to anything other than an expression that liquidated damage clauses in public construction contracts are not contrary to public policy and will be enforceable, assuming the remaining criteria for validity are met by the specific contract provision. But these remaining criteria are not found in old Section 1671; they were created by the case law which has

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substantially adopted the criteria of Restatement of Contracts §339. If the cross references are enacted the way you propose, every state and local agency subject to those statutes would be in a position to contend that they are at liberty to employ liquidated damage provisions in terms and amounts that would be deemed wholly arbitrary and unreasonable under the present law. I cannot believe that such a result is intended by the Commission. We all know that state and local government agencies never expressly say they want to do things in an unreasonable or arbitrary manner. All they want is that their discretion to draft contracts as they please shall be unreviewable so that they will not have to bother with the "interference" of judicial restraint. They wish to be the final judges of what is "reasonable".

Without researching the matter I have the impression, as a lawyer practicing in the area, that the applicable rule of California law derived from the cases is that expressed by Restatement of Contracts §339. In other words, all of us understand that the case law has departed from and superseded the words of old §1671. If this is true, and it represents the current judicial interpretation and application of old §1671, then what is the real difference between your proposed language in 1671(b) and 1671(d) containing the existing language?

Construction contracts, particularly public works contracts, can involve a great deal of money and the liquidated damage provisions can likewise involve comparatively large amounts of money. For example, a client recently was involved with a contract for some public buildings for a total price in the neighborhood of \$5 million and provided for liquidated damages for delay in completion of \$1250 a day. There was substantial delay in completion which was disputed as to its causes and who was at fault. The public entity refused to grant extensions of time and claimed an unexcused delay equal to damages in an amount exceeding \$300,000. After the usual negotiations over determining and allocating blame for the periods of delay and determining the proper date of substantial completion (beneficial occupancy), this was negotiated to a settlement, without litigation, at a substantially lesser amount. I am aware of another case in which the contractor had a contract of about \$1 million total price with a public agency in which the public agency refused to excuse delay equal at the contract rate to a deduction of about \$130,000. That case also was settled after negotiations over excusability of delay, extensions of time and the proper completion date. Both of these were contracts which antedated the 1973 enactment of Government Code §53069.85.

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Aside from the Government Code provisions, I believe the current case law routinely accepts the concept of liquidated damage provisions in construction contracts, whatever the literal terms of Civil Code §§1670 and 1671. Without researching it, I cannot recall any large construction contract in recent years, public or private, in or out of California, in which a court has invalidated a liquidated damages for delay provision on the general ground that it was contrary to policy. On the other hand, there are many cases, particularly U. S. Government cases, in which the liquidated damage amounts fixed have been held to be unreasonable and thereby invalid. Thus, I doubt that provisions like Government Code §14376 really add anything to what the law now is under the cases.

With regard to the matter of state and local government contracts, and private construction contracts as well, I believe the Commission (and the Legislature) should give consideration to the relationship that these rules will have to the established rules governing U. S. Government contracts. There are several reasons why I say this.

First of all, note that the California decisions arising out of public works construction contracts have frequently cited and followed the U. S. Government contract law. Two examples are cited in Professor Sweet's article. One of these is Hawley vs. Orange County Flood Control District, 211 C.A. 2d 708, 27 C.R. 478 (1963), Sweet, footnote 152. In this case the California court, after reviewing many prior California and federal cases, finally adopted the U. S. Government contract law rule which limits the effect of an unreasonable exculpatory provision commonly inserted by the public agencies. The other case is Nomellini Construction Co. vs. State, 19 C.A. 3d 240, 96 C.R. 682 (1971), Sweet, footnotes 166 and 179. The Nomellini case is very significant because it ended a long period of confusion in California law by stating some obvious common-sense rules about apportionment of delays and causes for delay where unexcused delay in completion of a contract results in the imposition of liquidated damages on a per day basis. The curious thing about the Nomellini decision is that it primarily quotes and relies upon a U. S. Supreme Court case decided over fifty years earlier. It illustrates how the state jurisprudence in this field after awhile follows the better developed federal case law. (What took fifty years?) There is vastly more U. S. Government contract law in this field due to the fact that the U. S. Government, especially since World War II, has let tens of thousands of contracts for tens or hundreds of billions of dollars with a resulting development of experience and law.

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A second reason for being concerned with U. S. Government contract law rules is in the nature of the construction contract business. The letting of bids and the performance of contracts is in a single market. A particular subcontractor or prime contractor specializes in types or functions ("trades") of construction. The "customer" who purchases the work might be a private party, the state or a local government or a federal government agency; but in all functional respects, the nature of the performance of the parties is the same no matter what "jurisdiction" is involved. It makes sense to avoid so far as possible unnecessary legal distinctions between performances which are otherwise functionally the same.

A third and important reason for considering U. S. Government contract law is the profound expansion and change in the role of the federal government generally in the past 30 or 40 years. The huge volume of construction contracting by the federal government and the experience and development of law in this area has occurred since the beginning of World War II. But even more important, in very recent years the federal government has been involved more or less, directly or indirectly, in a whole variety of programs by which it is a participant in some manner or a financier in some manner of a greater and greater proportion of all state, local, and even private contracting activity. The extent to which federal law exercises a paramount rule-making or law-making authority over these transactions is presently a subject of substantial discussion and has yet to be worked out. Before enacting some revision of the California law, consideration at least ought to be given to the federal government law and rules on the subject.

A fourth reason for considering the federal government contract law on the subject of liquidated damages is that it is very well developed and is generally considered fair to all concerned. The law is found in procurement regulations, court decisions and administrative decisions. The primary regulations are 41 CFR §§1-1.315, 1-18.113, governing civilian departments and agencies, ASPR 1-310, 18-110 [32 CFR §§1.310, 18.110] governing the Defense Department and 41 CFR §18-1.310 for NASA. Copies of several of these are attached. Some of the individual departments and agencies have subordinate implementing regulations. See, e.g., GSA: 41 CFR §5B-1.315; Agriculture: 41 CFR §4-1.315; Veterans Administration: 41 CFR §8-1.315; Transportation: 41 CFR §12-1.315. For a discussion of the regulations see: Young Associates v. U.S. (Ct.Cl. 1973) 471 F 2d 618, 621-622. The regulations probably replace a former statute, 40 USC former §269, repealed October 31, 1951. That statute was similar to Government Code §14376

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mentioned above. Cases arising under that repealed section are now annotated at 41 USC §256a and 10 USC §2312.

Similar to labor relations and tax law, the bulk of the cases are board decisions, not reported in the Federal Reporters, but reported by CCH. See McBride and Wachtel, Government Contracts, Part 34, and see CCH Government Contracts Reporter, ¶¶12610-12625.

Some examples of cases invalidating liquidated damage provisions:

Priebe & Sons v. U. S. (1947) 332 US 407
Pre-Con Inc. (IBCA) 74-2 BCA ¶10957
Old Atlantic Services, Inc. (ASBCA) 75-1 BCA ¶11190
Marathon Battery Co. (ASBCA) 64 BCA ¶4337

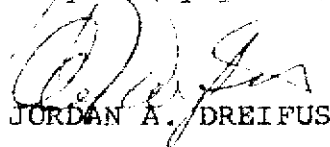
Some examples of cases upholding and enforcing liquidated damage provisions:

Young Associates v. U. S. (Ct.Cl. 1973) 471 F 2d 618
U.S. Mfg. and Galvanizing Corp. (GSBCA) 75-2 BCA ¶11447
Jennie-O Foods, Inc. (AGBCA) 74-2 BCA ¶10928

You will note that the regulations and the federal contract cases follow Restatement of Contracts §339.

I suggest that the Commission reexamine its proposal and develop specific reasonable standards for construction and similar contracts both public and private.

Very truly yours,


JORDAN A. DREIFUS

JAD/dr

Encs.

Military Construction Act shall not apply as impracticable. In addition, where appropriate provision is made in the invitation for bids or requests for proposals, separate award may be made on individual items whose price is within or not subject to any applicable cost limitation, and those items whose price is in excess of the limitations shall be rejected. Such a provision for separate award shall not be made unless determined to be in the best interest of the Government.

[§35,267.65]

18-111 Expediting Construction Contracts. No expediting action, advancing the completion date and involving additional costs under a contract funded under the provisions of the annual Military Construction Appropriation Act or any similar legislations, shall be taken without the prior approval of the Assistant Secretary of Defense (Installations and Logistics).

[§35,267.70]

18-112 Cost-Plus-A-Fixed Fee Contracts. Annual Military Construction Appropriation Acts provide that cost-plus-a-fixed-fee construction or architect-engineer contracts estimated to exceed \$25,000 to be performed within the United States, except Alaska, and to be charged to such appropriations shall not be executed unless the specific written approval of the Assistant Secretary of Defense (Installations and Logistics), setting forth the reasons therefor, is obtained.

[32 CFR §18.113]

18-113 Liquidated Damages. A liquidated damages clause shall be included in all contracts in excess of \$25,000 except cost-plus-fixed-fee contracts or those where the contractor cannot control the pace of the work. Use of a liquidated damages clause is optional for contracts of \$25,000 or less. Where such a provision is used, the clause set forth in 7-603.39 shall be included in the invitation for bids or request for proposals. Where different completion dates for separate parts or stages of the work are specified in the contract, this clause should be revised appropriately to provide for liquidated damages for delay of each separate part or stage of the work. The minimum amount of liquidated damages should be based on the estimated cost of inspection and superintendence for each day of delay in completion. Whenever the Government will suffer other specific losses due to the failure of the contractor to complete the work on time, such as the cost of substitute facilities, the rental of buildings, or the continued payment of quarters allowances, an amount for such items should also be included. Contracting officers shall take all reasonable steps to mitigate liquidated damages in accordance with 1-310(c) and may propose remissions of such damages in accordance with 1-310(d).

[§35,267.80]

18-114 Concurrent Firm Fixed Price and Cost Type Construction Contracts. In view of potential labor and administrative problems, contracts including cost-plus-a-fixed-fee, price-incentive or other cost variation or cost adjustment provisions shall not be awarded where performance is to be accomplished on the same project site where work on a firm fixed price construction contract is being performed, unless prior approval is obtained from the Head of a Procuring Activity; nor should a contractor performing a fixed price contract be awarded any contract, to be performed concurrently at the same site, which contains cost variation or cost adjustment features other than the standard renegotiation clause or price escalation, price redetermination or price incentive features.

[§35,267.85]

18-115 Construction Contracts With Design Architect-Engineers. No contract for construction of a project shall be awarded to the firm which designed the project or to its subsidiaries or affiliates, except with the approval of the Secretary of

itations for bids and requests for proposals shall include a statement of the magnitude in terms of physical characteristics of the proposed construction and by reference to the estimated price range (e.g., \$500,000-\$1,000,000). In no event shall such statement disclose the Government estimate.

[¶66,857.10]

[41 CFR
§1-18.110]

§ 1-18.110 Liquidated damages.

(a) A liquidated damages clause may, in the discretion of the contracting officer, be included in construction contracts. See § 1-1.315. Where such a provision is used, the invitation for bids or request for proposals shall include a clause reading substantially as follows:

LIQUIDATED DAMAGES

In case of failure on the part of the Contractor to complete the work within the time fixed in the contract or any extensions thereof, the Contractor shall pay to the Government as fixed, agreed and liquidated damages, pursuant to the clause of this contract entitled "Termination for Default-Damages for Delay-Time Extensions", the sum of \$..... for each calendar day of delay.

(b) Where different completion periods for separate parts or stages of the work are specified in the contract, this clause should be revised appropriately to provide for liquidated damages for delay in completion of each separate part or stage of the work as to which delay in completion will result in damage to the Government.

(c) The minimum amount of liquidated damages should be based on the estimated cost of inspection and superintendence for each day of delay in completion. Whenever the Government will suffer other specific losses due to the failure of the contractor to complete the work on time, such as the cost of substitute facilities, the rental of buildings, or the continued payment of quarters allowances, an amount for such items should also be included.

(d) Contracting officers shall take all reasonable steps to mitigate liquidated damages. With respect to remissions of such damages, see § 1-1.315-2(e).

[¶66,857.11]

§ 1-18.111 Concurrent firm fixed-price and cost-type construction contracts.

In view of potential labor and administrative problems, cost-plus-a-fixed-fee, price-incentive, or other types of contracts with cost variation or cost adjustment features will not be permitted concurrently with the same contractor and at the same work site, with firm fixed-price, lump sum, or unit price contracts except with the prior approval of the head of the procuring agency, or his authorized designee.

[¶66,857.12]

§ 1-18.112 Construction contracts with design architect-engineers.

No contract for construction of a project shall be awarded to a firm or person that designed the project, except with the approval of the head of the procuring agency, or his authorized designee.

[¶66,857.13]

§ 1-18.113 Architect-engineer services contracts.

Policies and procedures applicable to architect-engineer services contracts are set forth in Subpart 1-4.10 of this Title 41.

(38 FR 33596, 12/6/73, effective 1/14/74.)

[Subpart 1-18.2 begins on page 48,509.]

purpose. Requests for quotations may be issued for informational or planning purposes only with prior approval of an individual at a level higher than the contracting officer. In such cases, the request for quotation shall clearly state its purpose and, in addition, the following statement in capital letters shall be placed on the face of the request: "THE GOVERNMENT DOES NOT INTEND TO AWARD A CONTRACT ON THE BASIS OF THIS REQUEST FOR QUOTATION, OR OTHERWISE PAY FOR THE INFORMATION SOLICITED." The foregoing does not prohibit the allowance, in accordance with 18-205.3, of the cost of preparing such quotations.

(132,068)

{32 CFR §1.310}

1-310 Liquidated Damages.

(a) This paragraph 1-310 applies to procurement by formal advertising and procurement by negotiation. Liquidated damages provisions may be used when both (i) the time of delivery or performance is such an important factor that the Government may reasonably expect to suffer damages if the delivery or performance is delinquent, and (ii) the extent or amount of such damages would be difficult or impossible of ascertainment or proof. When a liquidated damages provision is to be used in a supply or service contract, insert the provision in 7-105.5 in accordance with the instructions thereof. Liquidated damage provisions for construction contracts are covered by 18-113, 7-603.39, and 8-709.

(b) When a liquidated damages clause is used, the contract shall set forth the amount which is to be assessed against the contractor for each calendar day of delay. The rate of assessment of liquidated damages must be reasonable considered in the light of procurement requirements on a case-by-case basis, since liquidated damages fixed without reference to probable actual damages may be held to be a penalty and therefore unenforceable. If appropriate to reflect the probable damages, considering that the Government can terminate for default or take other appropriate action, the rate of assessment of liquidated damages may be in two or more increments which provide a declining rate of assessment as the delinquency continues. The contract may also include an overall maximum dollar amount or period of time, or both, during which liquidated damages may be assessed, to assure that the result is not an unreasonable assessment of liquidated damages.

(c) The law imposes the duty upon a party injured by another to mitigate the damages which result from such wrongful action. Therefore, where a liquidated damages provision is included in a contract and a basis for termination for default exists, appropriate action should be taken expeditiously by the Government to obtain performance by the contractor or to terminate the contract. If delivery or performance is desired after termination for default, efforts must be made to obtain either delivery or performance elsewhere within a reasonable time. For these reasons, particularly close administration over contracts containing liquidated damages provisions is imperative.

(d) Whenever any contract includes a provision for liquidated damages for delay the Comptroller General on the recommendation of the Secretary concerned is authorized and empowered to remit the whole or any part of such damages as in his discretion may be just and equitable. Accordingly, recommendations concerning such remissions may be transmitted to the Secretary concerned in accordance with Departmental procedures.

hibit the allowance, in accordance with § 1-15.203-3, of the cost of preparing such quotations.

[§ 66,043]

§ 1-1.315 Use of liquidated damages provisions in procurement contracts.

§ 1-1.315-1 General.

This § 1-1.315 prescribes (a) policy which shall govern executive agencies in the use of liquidated damages provisions in contracts for supplies and services, including construction, entered into by formal advertising or by negotiation, and (b) a provision which shall be inserted in contracts for supplies and services, other than construction, when liquidated damages are stipulated.

[§ 66,043.20]

§ 1-1.315-2 Policy.

(a) Liquidated damages provisions may be used only where both (1) the time of delivery or performance is such an important factor in the award of the contract that the Government may reasonably expect to suffer damage if the delivery or performance is delinquent, and (2) the extent or amount of such damage would be difficult or impossible of ascertainment or proof.

(b) In making decisions as to whether liquidated damages provisions are to be used, consideration should be given to their probable effect on such matters as pricing, competition, and the costs and difficulties of contract administration, as well as the availability of provision elsewhere in the contract for recovery of excess costs in termination cases.

(c) The rate of liquidated damages stipulated must be reasonable in relation to anticipated damages, considered on a case-by-case basis, since liquidated damages fixed without any reasonable reference to probable damages may be held to be not compensation for anticipated damages caused by delay, but a penalty, and therefore unenforceable.

(d) Where a liquidated damages provision is included in a contract and a basis for termination for default exists, appropriate action should be taken expeditiously by the Government to obtain performance by the contractor or to exercise its right to terminate as provided in the contract. If delivery or performance is desired after termination for de-

fault, efforts must be made to obtain either delivery or performance elsewhere within a reasonable time. Efficient administration of contracts containing liquidated damages provisions is imperative to prevent undue loss to defaulting contractors and to protect the interests of the Government.

(e) Whenever any contract includes a provision for liquidated damages for delay, the Comptroller General, on the recommendation of the head of the agency concerned, is authorized and empowered, by law, to remit the whole or any part of such damages as in his discretion may be just and equitable.

[§ 66,043.30]

§ 1-1.315-3 Contract provisions.

(a) *Contracts for supplies or services.* When a liquidated damages provision is to be used in a contract which is for supplies or services and which includes Standard Form 32, General Provisions (Supply Contract), the following provision shall be inserted in the invitation for bids and an appropriate rate(s) of liquidated damages (determined pursuant to § 1-1.315-2) shall be stipulated:

LIQUIDATED DAMAGES

Article 11(f) of Standard Form 32, General Provisions (Supply Contract), is redesignated as Article 11(g) and the following is inserted as Article 11(f):

(f) (1) In the event the Government exercises its right of termination as provided in paragraph (a) above, the Contractor shall be liable to the Government for excess costs as provided in paragraph (b) above and, in addition, for liquidated damages, in the amount set forth elsewhere in this contract, as fixed, agreed, and liquidated damages for each calendar day of delay, until such time as the Government may reasonably obtain delivery or performance of similar supplies or services.

(2) If the contract is not so terminated, notwithstanding delay as provided in paragraph (a) above, the Contractor shall continue performance and be liable to the Government for such liquidated damages for each calendar day of delay until the supplies are delivered or services performed.

(3) The Contractor shall not be liable for liquidated damages for delays due to causes which would relieve him from liability for excess costs as provided in paragraph (c) of this clause.

(b) *Contracts for construction.* Liquidated damages provisions for construction contracts are contained in the Ter-

[Excerpt from Background Study, Sweet, Liquidated Damages in California, 60 Cal. L. Rev. 84, 116-123 (1972).]

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E. Construction Contracts

Careful lawyering at the drafting, pleading, and proof stages will make a liquidation clause for delay enforceable despite, on occasion, the availability of a recognized measure for actual damages and the lack of a genuine attempt to estimate damages. The enforceability of clauses liquidating damages for other types of breaches in construction contracts is less clear.

I. Owner Breaches

Liquidation in construction contracts typically concerns breaches by the contractor, because the owner's obligations are fewer in number and principally consist of making payments. There are, however, obligations of the owner that could be the subject of liquidation of damages clauses. For example, the owner might breach by an unexcused delay in furnishing the site to the contractor, by supplying incorrect soil data or by delaying the contractor's performance while on the site. But in construction contracts it is the owner who generally has the superior bargaining position, and he rarely feels the need to underliquidate damages for delay he causes. He uses a more direct approach to relieve himself of this risk, such as a clause permitting the owner to interrupt the contractor's work when in the owner's judgment it is necessary to do so¹⁵¹ or a clause limiting the contractor to an extension of time without any right to recover delay damages. The majority of courts enforce these "no damage" clauses,¹⁵² and a fortiori such courts should allow an owner to employ a liquidation clause to set the amount of damages.

But delay caused by the owner or misrepresentation of soil data generally increase the cost of doing the work to the contractor, and this is a type of damages that courts are generally able to handle. Since these costs are relatively easy to prove at the time of trial—apart from a possible dispute over causation or foreseeability—it is unlikely that a court would enforce a liquidated damages clause for these breaches. On the other hand, some types of owner breach, such as unjustifiable removal of the contractor from the project site, might create a situation where standardized measures of recovery are not sufficient for the contractor. For example, one standardized measure of recovery for the contractor is the cost of his part performance plus his profits; often contractors attempt to show profit margins by generally accepted profit margins in the construction industry, but a contractor might wish to agree in advance on an accepted profit margin. Such an agreement should be given effect.

151. But see CAL. CIV. CODE § 1511(1) (West 1970); Sweet, *Extensions of Time and Conditions of Notice: California's Needless Restrictions of Contractual Freedom*, 51 CALIF. L. REV. 720 (1963).

152. Sweet, *Owner-Architect-Contractor: Another Eternal Triangle*, 47 CALIF. L. REV. 645, 681 (1959). In *Hawley v. Orange County Flood Control Dist.*, 211 Cal. App. 2d 708, 27 Cal. Rptr. 478 (4th Dist. 1963), the court considered a "no damage" clause as creating a forfeiture and therefore held that it must be strictly construed, especially where the contract was prepared by the party seeking protection from his delay. The court finally concluded the clause did not apply to unreasonable delay caused by matters not within the contemplation of the parties.

2. *Contractor Breaches*

The principal contractor breaches are not entering into the contract when awarded, not constructing the project in accordance with the plans and specifications, unexcused delay in completing the project, and failing to pay subcontractors and suppliers. Of these, the principal areas for liquidation have been failure to enter into the contract when awarded and unexcused delay in completion, but one case has also arisen involving a clause liquidating damages for defective performance.

a. Defective performance. A 1909 case, *Sherman v. Gray*,¹⁵³ established that damages for a contractor's defective performance cannot be liquidated. The *Sherman* contract had a blunderbuss clause, one lump sum that applied to any breach by either party; it was clearly a penalty, and the court so held. However, the court did not rest its decision exclusively on the penalty aspect; it argued that, because the cost to correct any deficient work by the contractor would be a "simple, [sic] matter to ascertain,"¹⁵⁴ the case fits within the general rule against enforcing liquidated damages clauses where the damages are relatively easy to calculate at the trial. Since *Sherman*, no cases have ever arisen attempting to liquidate damages for a contractor's defective performance; the bar seems to have accepted that liquidation is inappropriate in these circumstances.

b. Failure to enter into a contract when awarded. At the outset it must be determined whether the parties properly attempted to liquidate damages. In the typical case each bidder must put up a specified percentage of his bid either by a certified check or bid bond. If this is all that is specified, it leaves open the question whether this amount constitutes an attempt to liquidate damages. Certainly if the contract purports to give the owner the option of treating the deposit as liquidated damages or suing for actual damages,¹⁵⁵ the amount should not be considered one of liquidated damages; a genuine liquidated damages clause must control the issue of the amount of damages. To be an unequivocal liquidation clause, the invitation to bidders should state that the amount deposited by the bidder is nonrefundable in the event the successful bidder has no legally sufficient reason for not entering into the contract, and for further safety it should at least recite the statutory language of section 1671 and that the amount is a reasonable endeavor to preestimate damages.

If a properly written clause establishes that the amount deposited

153. 11 Cal. App. 348, 104 P. 1004 (1st Dist. 1909).

154. *Id.* at 352, 104 P. at 1005.

155. Sometimes the option is given by law. See *Kemper Constr. Co. v. City of Los Angeles*, 37 Cal. 2d 696, 235 P.2d 7 (1951).

is an attempt to liquidate damages, the courts have disagreed as to whether it will be enforced.¹⁵⁶ However, in the most recent case on this issue, *Petrovich v. City of Arcadia*,¹⁵⁷ the California supreme court authoritatively settled the issue for this state. The action was brought by a successful bidder against the city of Arcadia to cancel his bid to construct sanitary improvements on the grounds of mistake: he had inadvertently omitted a large cost item. The city cross-complained, joined the surety, and asked for forfeiture of the bid bond for \$37,500 plaintiff had deposited. The next low bid was some \$69,000 higher than the plaintiff's bid. The supreme court's narrow holding in the case was only that, because neither the invitation to the bidders nor the bond explicitly provided for forfeiture, the city had to sue for actual damages.¹⁵⁸

Nevertheless, the court went on to discuss what would have been the result had the invitation or bond provided for forfeiture. The court concluded that, despite the contrary practice of several other jurisdictions,¹⁵⁹ in California compliance with section 1671 was a question of fact that must be alleged¹⁶⁰ and proved. Therefore in this case, even if the bid had been properly drafted, the city would fail, because there had been no specific showing of the difficulty of ascertaining actual damages or good-faith preestimation. Although this point is dictum, it appears to establish that sections 1670 and 1671 will be strictly applied in this area.¹⁶¹

This requirement of strict compliance may mean it will be impossible to liquidate damages for a contractor's failure to enter into the contract. Actual damages are usually not too difficult to determine. If the bidder does not enter into a contract awarded to him, there are at least three possibilities open to the awarding authority: it may award the contract to the next low bidder, it may readvertise and award the contract to the lowest responsible bidder, or it may decide to abandon the project. Unless the project is abandoned, major damages are generally easy to determine; they consist of the difference between the de-

156. Compare *City of Los Angeles v. Shafer*, 53 Cal. App. 458, 200 P. 384 (2d Dist. 1921) (enforcement refused) with *Palo & Dodini v. City of Oakland*, 79 Cal. App. 2d 739, 180 P.2d 764 (1st Dist. 1947) and *Town of Mill Valley v. Massachusetts Bonding & Ins. Co.*, 68 Cal. App. 372, 229 P. 891 (1st Dist. 1924) (enforcement granted).

157. 36 Cal. 2d 78, 222 P.2d 231 (1950).

158. *Id.* at 84-85, 222 P.2d at 236.

159. *Id.* at 83-84; 222 P.2d at 235-36; see 5 CORBIN § 1074.

160. But in *Bilardi Constr., Inc. v. Spencer*, 6 Cal. App. 3d 771, 86 Cal. Rptr. 406 (1st Dist. 1970), the court held a clause could be enforced despite the failure to plead compliance with section 1671 because the issue of validity was raised by the pretrial order.

161. See also CAL. ANN. GOV'T CODE §§ 37933, 37935 (West 1968) (city can retain security deposit, but it must return any portion that exceeds the difference between the bid originally accepted and the next low bid).

faulting bidder's bid and the bid that is ultimately accepted, and in cases where readvertising is necessary, the administrative expense of conducting another competitive bid. Delay in completion of the project, usually caused by readvertising or abandonment of the project, also usually causes major losses to the public, but they are unprovable. In addition, there will be minor damages, such as the administrative expense in having to deal with the bidder who is awarded the contract but refuses to enter into it.

The incidental losses, such as administrative expense, and the unprovable losses, such as inconvenience to the public, appear to have been ruled out as the bases for liquidation by the dictum in the *Petrovich* case. Such losses seem disproportionate to the amount deposited and it would not seem fair to make this the basis for liquidation. The delay caused by readvertising and the inconvenience to the public often caused by abandonment would seem sufficient to justify liquidation, but the *Petrovich* case was an abandonment case, so it appears that that issue has been resolved against liquidation.¹⁶²

c. *Unexcused delay.* Construction contracts frequently liquidate damages for unexcused delay by the contractor. Typically, delay is liquidated by assessing a specified amount or a percentage of the bid price¹⁶³ for each day of unexcused delay, although occasionally a lump sum liquidation is employed.¹⁶⁴ While a few cases have refused to enforce clauses setting damages for unexcused delay,¹⁶⁵ it is well settled in California that such clauses are enforceable.¹⁶⁶

162. If the awarding authority is concerned about losing minor damages, it could protect itself at the drafting stage by splitting the deposit into two parts, one for major and one for minor damages. For example, if the deposit would normally be 10%, the bidder would be asked to deposit an amount of 9% of his bid as a security deposit and 1% as liquidation for overhead and the intangible damages that could be caused if the successful bidder does not enter into the contract. In such a case the awarding authority would be able to sue for actual damages, with the 9% as security, and keep the 1% to cover administrative expenses.

163. E.g., *Broderick Wood Prods. Co. v. United States*, 195 F.2d 433 (10th Cir. 1952).

164. *Leslie v. Brown Bros., Inc.*, 208 Cal. 606, 283 P. 936 (1929); *Nash v. Hermosilla*, 9 Cal. 584 (1858).

165. *Patent Brick Co. v. Moore*, 75 Cal. 205, 16 P. 890 (1888) (failure to prove compliance with section 1671 in judgment roll case); *Muldoon v. Lynch*, 66 Cal. 536, 6 P. 417 (1885) (payment described in the clause as a forfeiture; long delay that did not appear to be the fault of the builder); *Nash v. Hermosilla*, 9 Cal. 584 (1858) (lump sum clause).

166. See *Peter Kiewit Son's Co. v. Pasadena City Junior College Dist.*, 59 Cal. 2d 241, 379 P.2d 18, 28 Cal. Rptr. 714 (1963), criticized in Sweet, *supra* note 151 *passim*; *Silva & Hill Constr. Co. v. Employers Mut. Liability Ins. Co.*, 19 Cal. App. 3d 914, 920, 97 Cal. Rptr. 498, 501 (2d Dist. 1971); *Nomellini Constr. Co. v. State ex rel. Dep't of Water Resources*, 19 Cal. App. 3d 240, 246, 96 Cal. Rptr. 682, 686 (3d Dist. 1971); *London Guar. & Acc. Co. v. Las Lomas School Dist.*, 191 Cal. App. 2d 423, 12 Cal. Rptr. 598 (1st Dist. 1961); *Hanlon Drydock & Shipbuilding Co. v.*

Most of the cases enforcing such clauses have been state public contracts. In such contracts the courts have been influenced by Government Code section 14376,¹⁶⁷ which provides that each state contract shall contain such a clause and that the clause determines the amount forfeited and paid to the state in the event of unexcused delay. In *Silva & Hill Construction Co. v. Employers Mutual Liability Insurance Co.*,¹⁶⁸ the court of appeals held that, while sections 1670 and 1671 apply generally to contracts between public agencies and private individuals, section 14376 of the Government Code is

a legislative determination that late charges imposed on a construction company by a state contract fall within the provisions of section 1671 of the Civil Code and as such are valid liquidated damages.¹⁶⁹

Recognizing that it would be difficult if not impossible to prove actual damages when a public project is not completed on time, the court argued that section 14376 is an attempt to overcome this so that the state will be at least partially reimbursed for additional cost, lost public benefits, and overhead expenses and that the contractor will be encouraged to work toward timely completion of the work.¹⁷⁰

Arguably, liquidation is less appropriate in commercial construction or public projects that have an establishable commercial use value. While a few cases in other jurisdictions have not enforced liquidation clauses in contracts involving the construction of residences,¹⁷¹ California's law seems established by *Hanlon Drydock & Shipbuilding Co. v. G.W. McNear, Inc.*,¹⁷² which upheld a *per diem* clause liquidating

G.W. McNear, Inc., 70 Cal. App. 204, 210, 232 P. 1002, 1004 (1st Dist. 1924) (ship repair delay).

167. CAL. ANN. GOV'T CODE § 14376 (West 1968).

168. 19 Cal. App. 3d 914, 97 Cal. Rptr. 682 (2d Dist. 1971).

169. *Id.* at 920, 97 Cal. Rptr. at 501.

170. *Id.* at 918, 97 Cal. Rptr. at 500. Similarly, in *Bethlehem Steel Corp. v. City of Chicago*, 350 F.2d 649, 650 (7th Cir. 1965), the court upheld a liquidated damages clause for delay that contained this recital:

The work under this contract covers a very important section of the South Route Superhighway, and any delay in the completion of this work will materially delay the completion of and opening of the South Route Superhighway thereby causing great inconvenience to the public, added cost of engineering and supervision, maintenance of detours, and other tangible and intangible losses.

171. See, e.g., *Cohn & Conway v. Birchard*, 124 Iowa 394, 100 N.W. 48 (1904); *Seeman v. Biemann*, 108 Wis. 365, 84 N.W. 490 (1900). However, some cases have enforced liquidation clauses that have substantially exceeded rental value when damages other than loss of use were reasonably foreseeable at the time the contract was made. See *Curtis v. Van Bergh*, 161 N.Y. 47, 55 N.E. 398 (1899); cf. *Brown Iron Co. v. Norwood*, 69 S.W. 253 (Tex. Civ. App. 1902). See also 5 CORBIN § 1072.

172. 70 Cal. App. 204, 232 P. 1002 (1st Dist. 1924). But see *General Ins. Co. v. Commerce Hyatt House*, 5 Cal. App. 3d 460, 472, 85 Cal. Rptr. 317, 325 (2d Dist. 1970) (liquidated damages are a penalty not favored in equity).

damages for delay in ship repair. This is reasonable. Even rental or use value of a residence or office building, while a well-accepted measure of recovery, can be difficult to establish. Also, delayed completion of a residence can involve damages in addition to loss of use.¹⁷³ Moreover, most contracts of this type are negotiated. Therefore, if the amount selected is within the range of likely damages, whether provable or not, such clauses should be enforced. While there is no available data on how liquidation amounts in these contracts are determined,¹⁷⁴ there is some instructive material by Elliott, a bridge engineer of the California Division of Highways, who states:

The sole purpose of a completion assessment is to assure that the contract work will be done within the time specified, . . . to threaten the Contractor with sufficient monetary loss so that he will find it advantageous to apply sufficient men and equipment to the work to get it done on time. Whereas moderate liquidated damages such as \$100 per day may well be used to insure the completion of a normal project having no special urgency, higher amounts are used to force faster work on jobs which must be finished in less than a normal construction time. High assessments may be used to emphasize the need for haste and should be of sufficient size to make it economically desirable that the contractor expedite his work by use of multiple shifts or additional equipment.¹⁷⁵

Although most such construction contract liquidation clauses would not pass muster as genuine attempts to estimate damages as required by section 1671, they are usually enforced. There are a number of reasons for this. First, while the liquidation amounts may not actually be bargained, the contractor can take this into account when he makes his bid.¹⁷⁶ Second, most construction contractors are not so unsophisticated as to merit special protection by the courts.¹⁷⁷ Third, courts enforce these clauses as a means of saving themselves from having to decide difficult fact questions relating to damages. Finally, these clauses are enforced because delays do cause losses, but the actual loss is often not provable under traditional damage rules, which require certainty, proof of causation, and foreseeability.

Apart from problems of enforceability, clauses liquidating damages

173. See note 171 *supra*.

174. The process was recently claimed to be constitutionally defective. See Brief for Contractor's Ass'n as Amicus Curiae, *Silva & Hill Constr. Co. v. Employer's Mut. Liab. Ins. Co.*, 19 Cal. App. 3d 682, 97 Cal. Rptr. 498 (2d Dist. 1971).

175. H. JONES, A. FARNSWORTH & W. YOUNG, *CASES AND MATERIALS ON CONTRACTS* 700 (1965).

176. *Id.* at 714.

177. See *Bethlehem Steel Corp. v. City of Chicago*, 350 F.2d 649, 651 (7th Cir. 1965); cf. *Southwest Eng'g Co. v. United States*, 341 F.2d 998 (8th Cir. 1965).

for contractor delay have caused difficulty because of a number of interpretation questions that have arisen. First, sometimes the delay is caused by the contractor and by the owner or someone for whose acts the owner is responsible. Because a court will not apportion responsibility for the total delay between those causes for which the contractor is responsible and those for which he is not,¹⁷⁸ the liquidated damages clause can be applied only if the parties provide for apportionment by contract.¹⁷⁹

The second interpretation problem courts frequently face is determining when a project is completed for liquidation purposes. The general answer is that actual, not substantial, completion is required.¹⁸⁰ However, courts will be hesitant to apply this rule where the stipulated damages are high and the project is available for use.¹⁸¹

A final interpretation problem that has troubled the courts is what happens when the contractor abandons the project and the liquidated damages clause is silent on abandonment. When this occurs, the owner typically hires another contractor to complete the project. In such a case, there can be two elements of damage. First, the total cost of the project may be increased because of the necessity of hiring another contractor and incurring a greater expense than originally specified in the contract. Generally, the owner is entitled to this additional expense as part of actual damages. Second, the contract will probably be completed by the substitute contractor beyond the contract date. Since two elements of damages are involved in these abandonment and completion-by-a-substitute-contractor cases, it would seem that the owner should be able to recover both his added costs in securing a substitute contractor and liquidation based upon when the project is actually completed, but the two California cases to consider this question have allowed only actual damages.¹⁸² This may be because when both of the items are totaled the damages can be quite formidable.

178. *General Ins. Co. v. Commerce Hyatt House*, 5 Cal. App. 3d 460, 85 Cal. Rptr. 317 (2d Dist. 1970); *Aetna Cas. & Sur. Co. v. Board of Trustees*, 223 Cal. App. 2d 337, 35 Cal. Rptr. 765 (1st Dist. 1963); *Gogo v. Los Angeles County Flood Control Dist.*, 45 Cal. App. 2d 334, 114 P.2d 65 (2d Dist. 1941). See Pettit & Gleason, *Liquidated Damage in Government Contracts*, 25 Sw. L.J. 264, 273 (1971).

179. *Nonellini Constr. Co. v. State ex rel. Dep't of Water Resources*, 19 Cal. App. 3d 240, 96 Cal. Rptr. 682 (3d Dist. 1971); Sweet, *supra* note 152, at 722.

180. See *London Guar. & Acc. Co. v. Las Lomas School Dist.*, 191 Cal. App. 2d 423, 12 Cal. Rptr. 598 (1st Dist. 1961).

181. See *Hungerford Constr. Co. v. Florida Citrus Exposition, Inc.*, 410 F.2d 1229 (5th Cir. 1969).

182. *Sinnott v. Schumacher*, 45 Cal. App. 46, 187 P. 105 (1st Dist. 1919); *Bacigalupi v. Phoenix Bldg. & Constr. Co.*, 14 Cal. App. 632, 112 P. 892 (1st Dist. 1910). See also *Six Companies v. Font Highway Dist. No. 13*, 311 U.S. 180 (1940).

ASSEMBLY BILL

No. 3169

Introduced by Assemblyman McAlister

February 23, 1976

REFERRED TO COMMITTEE ON JUDICIARY

An act to amend Sections 1671, 1951.5, and 3358 of, to add Section 1669 to, to add a title heading to Part 2 (commencing with Section 1549) of Division 3, immediately preceding Section 1671 of, to add a chapter heading to Title 4.5 (commencing with Section 1671) of Part 2 of Division 3 of, to add Chapter 2 (commencing with Section 1675) to Title 4.5 of Part 2 of Division 3 of, and to repeal Sections 1670 and 1676 of the Civil Code, to amend Sections 14376 and 53069.85 of the Government Code, and to amend Section 5254.5 of the Streets and Highways Code, relating to legal obligations, including liquidated damages.

LEGISLATIVE COUNSEL'S DIGEST

AB 3169, as introduced, McAlister (Jud.). Liquidated damages.

Under existing law, liquidated damages provisions in contracts are enforceable only when it would be impracticable or extremely difficult to fix the actual damage.

This bill would also permit, with specified exemptions, the enforcement of such contractual liquidated damage provisions except where the provision was unreasonable under the circumstances at the time of the making of the contract, where the party from whom liquidated damages are sought was in a substantially inferior bargaining position at the time the contract was made, or where the liquidated damages are

sought to be recovered from a party to a contract for property or services for a personal, family or household purpose or to a lease of real property for use as a dwelling by the party.

The bill would further prescribe the use of liquidated damages in defaults on real property purchase contracts and would make technical and conforming changes.

This bill would become operative on July 1, 1977, and be applicable to contracts made on or before July 1, 1977.

Vote: majority. Appropriation: no. Fiscal committee: no. State-mandated local program: no.

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

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

3 1669. Every contract in restraint of the marriage of
4 any person, other than a minor, is void.

5 SEC. 2. Section 1670 of the Civil Code is repealed.

6 1670. Every contract by which the amount of damage
7 to be paid, or other compensation to be made, for a
8 breach of an obligation, is determined in anticipation
9 thereof, is to that extent void, except as expressly
10 provided in the next section.

11 SEC. 3. A title heading is added to Part 2
12 (commencing with Section 1549) of Division 3 of the
13 Civil Code, immediately preceding Section 1671 thereof,
14 to read:

15
16 TITLE 4.5. LIQUIDATED DAMAGES

17
18 SEC. 4. A chapter heading is added to Title 4.5
19 (commencing with Section 1671) of Part 2 of Division 3
20 of the Civil Code, immediately preceding Section 1671, to
21 read:

22
23 CHAPTER 1. GENERAL PROVISIONS

24
25 SEC. 5. Section 1671 of the Civil Code is amended to
26 read:

27 1671. (a) This section does not apply in any case

1 where another statute expressly applicable to the
2 contract prescribes the rules or standard for determining
3 the validity of a provision in the contract liquidating the
4 damages for the breach of the contract.

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

11 (c) The validity of a liquidated damages provision
12 shall be determined under subdivision (d) and not under
13 subdivision (b) in either of the following cases:

14 (1) Where the party from whom the liquidated
15 damages are sought to be recovered establishes that he
16 was in a substantially inferior bargaining position at the
17 time the contract was made.

18 (2) Where liquidated damages are sought to be
19 recovered (i) from a party to a contract for the retail
20 purchase, including rental, by such party of personal
21 property or services, primarily for the party's personal,
22 family, or household purposes, or (ii) from a party to a
23 lease of real property for use as a dwelling by the party.

24 (d) In the cases described in subdivision (c), a
25 provision in a contract liquidating damages for the
26 breach of the contract is void except that the parties
27 to such a contract may agree therein upon an amount
28 which shall be presumed to be the amount of damage
29 sustained by a breach thereof, when, from the nature of
30 the case, it would be impracticable or extremely difficult
31 to fix the actual damage.

32 SEC. 6. Section 1676 of the Civil Code is repealed.

33 ~~1676. Every contract in restraint of the marriage of~~
34 ~~any person, other than a minor, is void.~~

35 SEC. 7. Chapter 2 (commencing with Section 1675)
36 is added to Title 4.5 of Part 2 of Division 3 of the Civil
37 Code, to read:

1 CHAPTER 2. DEFAULT ON REAL PROPERTY
2 PURCHASE CONTRACT

3
4 1675. (a) As used in this section, "residential
5 property" means real property primarily consisting of a
6 dwelling that meets both of the following requirements:

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

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

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

21 (c) To the extent that the amount paid does not
22 exceed 5 percent of the purchase price, such amount is
23 valid as liquidated damages unless the buyer establishes
24 that such amount was unreasonable as liquidated
25 damages under the circumstances existing at the time the
26 contract was made. To the extent that the amount paid
27 exceeds 5 percent of the purchase price, such excess
28 amount is valid as liquidated damages only if the seller
29 establishes that such excess amount was reasonable as
30 liquidated damages under the circumstances existing at
31 the time the contract was made.

32 1676. (a) Except as provided in Section 1675, a
33 provision in a contract to purchase and sell real property
34 liquidating the damages to the seller if the buyer fails to
35 purchase the property is valid if it satisfies the
36 requirements of Sections 1677 and 1678 and the
37 requirements of either subdivision (b) or (c) of this
38 section.

39 (b) The liquidated damages provision is valid if it
40 satisfies the requirements of subdivision (b) or (c) of

1 Section 1671, whichever subdivision is applicable.

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

11 1677. A provision in a contract to purchase and sell
12 real property liquidating the damages to the seller if the
13 buyer fails to purchase the property is invalid unless:

14 (a) The provision is separately signed or initialed by
15 each party to the contract; and

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

19 1678. If more than one payment made by the buyer
20 is to constitute liquidated damages under Section 1675 or
21 subdivision (c) of Section 1676, the amount of any
22 payment after the first payment is valid as liquidated
23 damages only if (1) it satisfies the requirements of
24 Section 1675 or subdivision (c) of Section 1676, whichever
25 applies, and (2) a separate liquidated damages provision
26 satisfying the requirements of Section 1677 is separately
27 signed or initialed by each party to the contract for each
28 such subsequent payment.

29 1679. This chapter applies only to a provision for
30 liquidated damages to the seller if the buyer fails to
31 purchase real property. The validity of any other
32 provision for liquidated damages in a contract to
33 purchase and sell real property is determined under
34 Section 1671.

35 1680. Nothing in this chapter affects any right a party
36 to a contract for the purchase and sale of real property
37 may have to obtain specific performance.

38 1681. This chapter does not apply to real property
39 sales contracts as defined in Section 2985.

40 SEC. 8. Section 1951.5 of the Civil Code is amended

1 to read:

2 1951.5 ~~Sections 1670 and Section 1671, relating to~~
3 liquidated damages, ~~apply~~ *applies* to a lease of real
4 property.

5 SEC. 9. Section 3358 of the Civil Code is amended to
6 read:

7 3358. ~~Notwithstanding the provisions of this Chapter,~~
8 *Except as expressly provided by statute*, no person can
9 recover a greater amount in damages for the breach of an
10 obligation than he could have gained by the full
11 performance thereof on both sides; ~~except in the cases~~
12 ~~specified in the Articles on Exemplary Damages and~~
13 ~~Penal Damages, and in Sections 3319, 3339, and 3349.~~

14 SEC. 10. Section 14376 of the Government Code is
15 amended to read:

16 14376. Every contract shall contain a provision in
17 regard to the time when the whole or any specified
18 portion of the work contemplated shall be completed,
19 and shall provide that for each day completion is delayed
20 beyond the specified time, the contractor shall forfeit and
21 pay to the state a specified sum of money, to be deducted
22 from any payments due or to become due to the
23 contractor. A contract for a road project may also provide
24 for the payment of extra compensation to the contractor,
25 as a bonus for completion prior to the specified time, such
26 provision, if used, to be included in the specifications and
27 to clearly set forth the basis for such payment. *Section*
28 *1671 of the Civil Code does not apply to contract*
29 *provisions under this section.*

30 SEC. 11. Section 53069.85 of the Government Code is
31 amended to read:

32 53069.85. The legislative body of a city, county or
33 district may include or cause to be included in contracts
34 for public projects a provision establishing the time
35 within which the whole or any specified portion of the
36 work contemplated shall be completed. The legislative
37 body may provide that for each day completion is
38 delayed beyond the specified time, the contractor shall
39 forfeit and pay to such agency involved a specified sum
40 of money, to be deducted from any payments due or to

1 because due to the contractor. A contract for such a
2 project may also provide for the payment of extra
3 compensation to the contractor, as a bonus for
4 completion prior to the specified time. Such provision,
5 if used, shall be included in the specifications upon which
6 bids are received, which specifications shall clearly set
7 forth the provisions. *Section 1671 of the Civil Code does*
8 *not apply to contract provisions under this section.*

9 SEC. 12. Section 5254.5 of the Streets and Highways
10 Code is amended to read:

11 5254.5. At any time prior to publication and posting
12 notice inviting bids, the legislative body by resolution,
13 may determine that in the event that the contractor,
14 contracting owners included, does not complete the work
15 within the time limit specified in the contract or within
16 such further time as the legislative body shall have
17 authorized, the contractor or contracting owners, as the
18 case may be, shall pay to the city liquidated damages in
19 the amount fixed by the legislative body in said
20 resolution. If such determination is made, the plans or
21 specifications and the contract shall contain provisions in
22 accordance therewith.

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

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

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

32 (3) If a contribution has theretofore been made or
33 ordered by any agency, the legislative body may order a
34 refund to the contributing agency in the proportion
35 which said contribution bears to the total costs and
36 expenses of the work. *Section 1671 of the Civil Code does*
37 *not apply to liquidated damages provisions under this*
38 *section.*

39 SEC. 13. This act shall become operative on July 1,
40 1977.

1 SEC. 14. This act applies only to contracts made on or
2 after July 1, 1977.