Title 4.5: California Liquidated Damages

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TITLE 4.5: CALIFORNIA LIQUIDATED DAMAGES

Recent criticisms of California's liquidated damages law prompted the California Legislature to substantially rewrite the law in this area. The new law was passed in 1977 and became effective in July of 1978. A presumption of validity for most liquidated damages clauses replaces a century-old presumption of invalidity. This Comment examines the rationale behind the new law, discusses relevant portions of the enactment, and analyzes any ambiguities which may still exist.

In July 1978, legislation became effective which dramatically altered liquidated damages law in California. The new legislation attempts to inject more certainty into an area previously fraught with confusion. In most instances, the new law reflects a one hundred eighty degree change from prior liquidated damages law. The new statutory scheme provides for a "presumption of validity" when a liquidation clause is agreed to by the parties. Under the old law, liquidation clauses were generally presumed invalid.

The new liquidated damages law is embodied in title 4.5 of the California Civil Code. This Comment will examine the purposes of the new legislation and the legislation's probable effect. Part one presents a brief history of liquidated damages law before the enactment of title 4.5; part two discusses the legislative history of the act; part three considers the impact of title 4.5; part four examines the ambiguities in the law; and part five constitutes a critical analysis and conclusions.


3. See text accompanying notes 5-15 infra.

The term "liquidated damages" denotes a specific sum fixed by the contracting parties to be paid in the event of breach. Liquidated damages generally limit a party's liability for breach of contract.

Prior to the enactment of title 4.5, the object and usual effect of a liquidated damages provision was to allow the injured party to recover for actual injury suffered without proving the specific elements of damage. A plaintiff who sued under a liquidated damages clause did not have to allege or prove any actual damages. However, if the defendant could affirmatively show that there were no actual damages, the court could deny enforcement of the liquidation clause. Consequently, most California courts did not enforce liquidated damages clauses if there were no actual damages.

General Rule

California liquidated damages law was primarily governed by California Civil Code sections 1670 and 1671. Sections 1670 and 1671 provided: "Every contract by which the amount of damage to be paid . . . for a breach of an obligation is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section." CAL. CIV. CODE § 1670 (West 1978) (repealed 1978).
1671 created a presumption of invalidity for liquidated damages provisions, subject to specified exceptions. The liquidated damages clause was valid if, when the contract was made, the damages that would arise from a breach were difficult to ascertain. The clause remained enforceable even if at the time of trial no such difficulty existed. However, a mere recital in a contract that damages for breach would be impracticable or difficult to ascertain was not conclusive. Rather, the party seeking to enforce a liquidated damages provision had to plead and prove that the facts of the case brought the provision within the ambit of Civil Code section 1671. The test, which placed the court in the position of the parties when the contract was made, was described as the look-forward test. The look-forward test was adopted in California in 1953 in Better Foods Markets, Inc. v. American District Telephone Co.

A different type of provision occasionally classified as a liquidation clause is a limitation of liability provision. This type of provision differs from a liquidation clause in several respects. A limitation of liability provision does not: (1) attempt to estimate damages; (2) relieve the breaching party from actual damages; (3) require that damages be difficult to ascertain; or (4) limit recovery to a fixed sum. Additionally, any recovery under a limitation of liability provision must be proven. Limitation provisions arose from the increasingly strong desire of contracting parties to limit...
the scope of their risk. Courts may hesitate to enforce these liability limitations because of what they conceive to be public policy.

If a provision is construed as calling for alternative performance, sections 1670 and 1671 are inapplicable. The test to determine whether a contract clause calls for alternative performance is whether the parties reasonably believe they have a choice of true alternatives to pursue. The alternative performance contract evolved into a useful tool in enforcing remedy clauses without complying with section 1670 or 1671.

Liquidated Damages Provisions in Specific Types of Contracts

Construction Contracts

Liquidation clauses in construction contracts usually concern breaches by the contractor and not the owner, whose major obligation is to pay for the work performed. The principal contractor breaches have been (1) failure to sign a contract when awarded, (2) violating the project's plans in the construction, (3) unexcused delay, and (4) failure to pay subcontractors and suppliers.

Generally, damages for a contractor's defective performance cannot be liquidated. In Petroleum v. City of Arcadia, the California Supreme Court stated that unless the city specifically pleaded and proved the difficulty of ascertaining actual damages or good-faith pre-estimation, the liquidation clause would fail. Because actual damages are usually easy to determine, Petroleum invalidates the application of liquidation clauses to a contractor's failure to sign a contract when awarded.

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20. See Sweet, supra note 5, at 93.
24. The authors have concentrated their examination of contracts under the old law to those materially affected by the enactment of title 4.5. For a comprehensive survey of liquidation clauses under the old law, see Sweet, note 5 supra.
25. Sweet, supra note 5, at 117.
26. It is well established in California that damages for a contractor's defective performance cannot be liquidated. See Sherman v. Gray, 11 Cal. App. 348, 104 P. 1004 (1909); Sweet, supra note 5, at 118.
27. 36 Cal. 2d 78, 222 P.2d 231 (1950).
28. Id. at 86, 222 P.2d at 237. See also Cal. Gov't Code §§ 37333, 37335 (West 1968) (city may retain security deposit, but it must return any portion that exceeds the difference between the original bid accepted and the next low bid).
29. Contract provisions should be distinguished from municipal ordinance re-
Liquidation clauses setting damages for unexcused delay are usually enforced. The vast majority of the cases enforcing these clauses involve state public agencies and are controlled by section 14376 of the Government Code, which sanctions late charges imposed on a construction company by a state contract as valid liquidated damages within the purview of section 1671 of the Civil Code.

Lease Contracts

A simple liquidation clause in a lease is usually invalid. Therefore, if money is paid as security for the performance of the terms of a lease and is subject to forfeiture, it is an unenforceable penalty and cannot be retained by the lessor. These clauses are unenforceable because the actual damages resulting from the lessee's breach are readily ascertainable. Lessors have unsuccessfully attempted to enforce liquidation clauses by characterizing them as acceleration clauses.

However, in some exceptional cases, liquidation clauses in leases have been enforced. A liquidation clause was upheld when a default by the lessee would have seriously impaired the goodwill of a business in a commercial setting. An absolute payment requirement that compels a bidder on a municipal contract to deposit a certain sum with his bid, to be forfeited on failure to enter into the contract if awarded. Such a requirement is valid and is viewed as a necessary means of carrying out the objective of good faith competitive bidding. A & A Elec., Inc. v. King, 54 Cal. App. 3d 457, 126 Cal. Rptr. 585 (1976). See Sweet, supra note 5, at 118.

30. Typically, delay is liquidated by assessing a specified amount or a percentage of the bid price for each day of unexcused delay, although occasionally a lump sum is used. Leslie v. Brown Bros., Inc., 208 Cal. 606, 283 P. 936 (1929); Nash v. Hermosilla, 9 Cal. 584 (1853).

31. Peter Kiewit Sons' Co. v. Pasadena City Junior College Dist., 59 Cal. 2d 241, 379 P.2d 18, 28 Cal. Rptr. 714 (1963); Sweet, supra note 5, at 120.

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


34. Redmon v. Graham, 211 Cal. 491, 295 P. 1031 (1931); Fox Chicago Realty, Ltd. v. Zukor's, 50 Cal. App. 2d 129, 122 P.2d 705 (1942); Sweet, supra note 5, at 100.

35. E.g., on default by the lessee and 30 days' notice thereof, the entire rent shall become due. In Ricker v. Rambough, 120 Cal. App. 2d 912, 261 P.2d 328 (1953), this provision was held invalid as an obvious penalty. The court distinguished the valid acceleration clause in a promissory note from the acceleration clause in a lease. The former requires the debtor to pay a sum for which he has already received the entire consideration, whereas the latter requires the lessee to pay for occupancy that he did not receive. See Puritan Leasing Co. v. August, 16 Cal. 3d 461, 546 P.2d 679, 128 Cal. Rptr. 175 (1976).

36. McCarthy v. Tally, 95 Cal. 2d 577, 297 P.2d 981 (1956). The court here up-
of rent in advance—for example, covering the last part of the term—was valid, and the money paid could be retained by the lessor.\textsuperscript{37} The validity of a clause providing for payment of a bonus in consideration for execution of a lease was upheld even though the lease provided that in the event of faithful performance the amount would be credited to the last rental payment.\textsuperscript{38} A clause providing for forfeiture if the lessee voluntarily terminated the lease was upheld under the rationale that the money was not taken as damages for breach.\textsuperscript{39} A provision fixing a sum as rental to be paid if the lessee held over after the expiration of the lease was also enforced.\textsuperscript{40} Finally, a provision calling merely for a deposit as security for performance, without a forfeiture clause, was valid. The entire sum could not be taken on breach, but was a source of payment of actual damages proved with any balance returned to the lessee.\textsuperscript{41}

Liquidation clauses in rental agreements for residential property have always been heavily regulated. Section 1950.5 of the Civil Code\textsuperscript{42} applies to security for a rental agreement for residential property—"property used as the dwelling of the tenant."\textsuperscript{43} The Civil Code defines security as "any payment, fee, deposit or charge, including, but not limited to, an advance payment of rent, used or to be used for any purpose."\textsuperscript{44} Security deposits on unheld an ordinary liquidated damages clause for a large sum ($10,000). The property was a summer resort, and default by the lessee during the season would have seriously impaired the goodwill of the business.

\textsuperscript{37} Warming v. Shapiro, 118 Cal. App. 2d 72, 257 P.2d 74 (1953). \textit{Cf.} Butt v. Bertola, 110 Cal. App. 2d 128, 242 P.2d 32 (1952) (the lessor sought to retain the payment after his own act of eviction, relying on the provision that the lessee could not reclaim the money if the lessee terminated "for any cause or reason whatsoever." The court refused to construe this language as authorizing the lessor wrongfully to deprive the lessee of his last six months of the term).


\textsuperscript{39} Kuhlemeier v. Lack, 50 Cal. App. 2d 862, 123 P.2d 918 (1942). The court thought that the bonus cases were on point. "If such a payment can be upheld as a consideration for entering into a lease, it would appear equally logical to sustain it as consideration for the right to terminate the lease." \textit{Id.} at 806, 123 P.2d at 921. \textit{See} Folden v. Lobrovich, 171 Cal. App. 2d 627, 341 P.2d 368 (1959).

\textsuperscript{40} Vucinich v. Gordon, 51 Cal. App. 2d 434, 124 P.2d 868 (1942).

\textsuperscript{41} Ace Realty Co. v. Friedman, 106 Cal. App. 2d 805, 236 P.2d 174 (1951).


\textsuperscript{43} CAL. CIV. CODE § 1950.5(a) (West Supp. 1978). To the extent that it is a recodification of the former section, it applies to payments or deposits made on or after January 1, 1971; the changes made by the new section apply to rental agreements created or renewed on or after January 1, 1978. \textit{Id.} § 1950.5(k).

\textsuperscript{44} \textit{Id.} § 1950.5(b). Security includes, but is not limited to: (1) compensation to a landlord for a tenant's default in rent payment, (2) repair of damages to the premises caused by the tenant, and (3) cleaning the premises upon termination of the tenancy.
furnished residential property are limited to the amount of two months' rent while deposits on furnished residential property are limited to three months' rent. Both amounts may be in addition to rent for the first month paid on or before occupancy.\footnote{Id. § 1950.5(c). The subdivision does not prohibit an advance payment of at least six months' rent if the term of the lease is six months or longer. Additionally, it does not prohibit a mutual agreement under which the landlord, at the tenant's request and for a specified charge, makes "structural, decorative, furnishing, or other similar alteration" other than cleaning and repairing for which the previous tenant may be charged. \textit{Id.}}

The lessor may claim "only such amounts as are reasonably necessary to remedy tenant defaults in the payment of the rent, to repair damages to the premises caused by the tenant, exclusive of ordinary wear and tear, or to clean such premises, if necessary, upon termination of the tenancy."\footnote{Id. On termination of the lessor's interest in the dwelling unit, whether by sale, assignment, death, appointment of receiver, or otherwise, the lessor must do one of the following in order to relieve himself of liability with respect to the security: (1) transfer to the successor in interest the portion of the security remaining after lawful deductions and notify the tenant of the transfer or (2) return to the tenant the portion of the security remaining after lawful deduction with an accounting. The notification may be made by certified mail or by personal delivery. In the former case the tenant must sign an acknowledgment of receipt of the notice. The notification must include the transferee's name, address, and telephone number. \textit{Id.} § 1950.5(f). On receipt of any portion of the security under subdivision (f), the transferee has all of the rights and obligations of a landlord with respect to such security. \textit{Id.}} No later than two weeks after the tenant has vacated the premises, the lessor must give him an itemized written statement of the reason for and the amount of any security retained.\footnote{Id. Any lease which characterizes a security as "nonrefundable" is expressly prohibited by the section. \textit{Id.} § 1950.5(i). Finally, an action under the section may be maintained in the small claims court if the damages claimed (actual or punitive or both) are within the jurisdictional amount of Civil Procedure Code § 116.2. \textit{Id.} § 1950.5(j).} Any remaining portion of the security must be returned to the lessee.\footnote{Id. § 1950.7.} 

Section 1950.7 of the Civil Code\footnote{Id.} applies to rental agreements
for other than residential property. The lessor may claim "only such amounts as are reasonably necessary to remedy tenant defaults in the payment of rent, to repair damages to the premises caused by the tenant, or to clean such premises upon termination of the tenancy, if the payment or deposit is made for any or all of those specific purposes." Any remaining portion of the payment or deposit must be returned to the lessee no later than two weeks after termination of his tenancy.

Real Property Purchase Contracts

For years, liquidated damages clauses have routinely been inserted in land sales contracts. The primary reason for the insertion of such clauses is the seller's desire to keep the land and as much of the purchase price as possible upon the buyer's default. However, case law has made the enforcement of such provisions unpredictable. Confusion resulted "because courts have endorsed them [liquidated damages clauses] in principle, although they have been reluctant to enforce such clauses in any actual case."

Apparently, such clauses have been inserted because of the anticipated psychological effect on the buyer. Law in the area has been so unstable that in most instances, a reasonable drafter

50. California Civil Code § 1950.7 applies to (1) any payment or deposit of money "the primary function of which is to secure the performance of a rental agreement for other than residential property," or (2) any part of such an agreement "other than a payment or deposit, including an advance payment of rent, made to secure the execution of a rental agreement." Id. § 1950.7(a).

The section applies to all tenancies, leases, or rental agreements for other than residential property created or renewed on or after January 1, 1971. Id. § 1950.7(g).

51. Id. § 1950.7(c).

52. Id. The duties and responsibilities imposed on the lessor on termination of his interest in the premises are identical to those provided in Civil Code § 1950.5(f). Id. § 1950.5(f). See text accompanying notes 47-48 supra; CAL. CIV. CODE §§ 1950.7(d), .7(e) (West Supp. 1978). As in section 1950.5(h), the bad faith retention of any portion of a payment or deposit in violation of this section "may" subject the lessor or transferee to punitive damages of not more than $200 in addition to actual damages. Id. § 1950.7(f).

53. The California Real Estate Association has recommended a standard form to be used for liquidated damages clauses in land sale contracts. The form has been in use since 1967 and reads as follows:

[S]eller recognizes that buyer will spend time and effort preparing for the acquisition of this property, and buyer recognizes that seller's property will be removed from the market during the existence of this agreement. Both parties agree that if either fails to perform under this contract, the other should be entitled to compensation for the detriment described above, but that it is extremely difficult and impractical to ascertain the extent of the detriment.


could not expect that the clause would be upheld in the event of the buyer's breach. However, such clauses have been effective. They have undoubtedly reduced the number of buyer defaults because of the "threat" of the loss of the liquidated sum. Further, liquidation clauses have probably reduced the number of buyers' suits for restitution to recover the "liquidated" amount retained by the seller.55

The confusion regarding liquidated damages clauses in realty sales contracts has existed for almost eighty years. To understand the situation fully, it is necessary to review briefly the history of the rules relating to liquidated damages clauses in real property sales contracts.56

Early case law decisions allowed the defaulting buyer to recover his deposit but only to the extent that it exceeded actual damages.57 In the landmark case of *Drew v. Pedlar*, the California Supreme Court refused to uphold the validity of a liquidated damages clause. The court stated:

> It appears from the nature of the contract under consideration that it would not be impracticable, or at all difficult, to fix the actual damage in this case, since section 3307 of the Civil Code provides a rule by which the damage in *all cases of this kind* may be measured and definitely fixed ... 58

Thus the court reasoned that section 3307 of the Civil Code provided an adequate remedy for the seller in the case of a buyer's default.

In 1898 the California Supreme Court decided *Glock v. Howard*.59 The court, although not expressly overruling *Drew*, held

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58. *Id.* at 450, 25 P. at 751 (emphasis added). California Civil Code § 3307 states the measure of damages for the breach of real property purchase agreements. It provides: "The detriment caused by the breach of an agreement to purchase an estate in real property, is deemed to be the excess, if any, of the amount which would have been due to the seller, under the contract, over the value of the property to him." Cal. CIV. Code § 3307 (West 1970).

59. 123 Cal. 1, 55 P. 713 (1898).
that liquidated damages clauses were valid. *Glock* was the law in California for over fifty years.60

In 1949 the California Supreme Court tacitly reversed the rule of law established by *Glock*.61 In that year the court in *Barkis v. Scott*62 held that a buyer who defaulted in good faith could invoke Civil Code section 327563 to prevent forfeiture of all payments made under a liquidation clause in the contract.

In 1951 the California Supreme Court extended the protection offered to buyers by *Barkis*.64 In *Freedman v. Rector*,65 the court allowed a willfully defaulting buyer to recover an amount retained by the seller as liquidated damages. However, the court did not rely on section 3275 of the Civil Code in fashioning a remedy for the buyer.66 Rather, the court found an alternative remedy. In *Freedman*, the buyer established that shortly after the breach the seller had sold the property for an amount greatly in excess of the contract price. The court determined that to allow the seller to retain the buyer's deposit would constitute an award of punitive damages to the seller. The court, in granting restitution, said, “Since defendant resold the property for . . . more than plaintiff agreed to pay for it, it is clear defendant suffered no damage as a result of plaintiff’s breach.”67 Further, “[T]he damage provisions of the Civil Code together with the policy of the law against penalties and forfeitures provide an alternative basis for

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60. Until approximately 1950, *Glock v. Howard* was the most frequently cited case on the California rule for liquidated damages in a land sales contract. This is interesting considering that the concept of liquidated damages was extraneous to its analysis. According to the *Glock* court, the seller had a choice of several remedies in the event of a buyer's default. The choice included benefit of the bargain damages, specific performance, retention of the liquidated sum, and rescission. *Id.*

61. *Id.*


63. *Id.* California Civil Code § 3275 provides:

   Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty.

CAL. CIV. CODE § 3275 (West 1970).

It is interesting that in *Glock v. Howard*, 123 Cal. 1, 55 P. 713 (1898), the court tried to clarify the situation by citing all the statutes the court deemed pertinent. For some reason Civil Code § 3275 was not mentioned even though it had been in existence for six years. In some cases, though, the court had granted relief from forfeiture in particularly harsh cases. See, e.g., *Hayt v. Bentel*, 164 Cal. 680, 130 P. 432 (1913).


66. *Id.* Section 3275 does not allow relief from forfeiture in the case of a willful breach. Hence relief under that section was unavailable to the buyer. See CAL. CIV. CODE § 3275 (West 1970).

relief independent of section 3275.”

Freedman did not preclude the use of the liquidated damages clause in all situations. In fact, the court stated that such clauses were “presumptively valid” if the down payment was reasonable. However, the court stated that the seller had to return the liquidated sum if evidence established that it “would not be impracticable or extremely difficult to fix the actual damage.”

Freedman caused much confusion. On the one hand, the court stated that liquidated damages clauses were “presumptively valid.” On the other hand, dicta in the case suggested that as a practical matter the seller would not be able to retain the deposit in most instances. Uncertainty in the area prompted attorneys to devise various means of circumventing the liquidated damages rule. The majority of these devices met with only limited success. Retention of payments by the seller was “justified” on a number of theories. Most involved “fictional recitals of various types, such as declarations that the deposits were ‘earned consideration’ or ‘separate consideration’ for entering into the contract.”

Case law of the 1960s and early 1970s reflected the courts’ difficulty with the seemingly inconsistent liquidated damages rules. Drafting a valid liquidated damages provision proved difficult, if not impossible, in most instances; and courts were reluctant to enforce the clause even when it appeared to comply with the

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68. Id.
69. Id. at 23, 230 P.2d at 633.
70. Id.
71. Id.
72. See id. at 16, 230 P.2d at 629.
73. Sweet, supra note 5, at 97. The separate-consideration recital failed in Rodriguez v. Barnett, 52 Cal. 2d 154, 338 P.2d 907 (1959). In Rodriguez the court allowed the buyer to recover his payment even though a clause in the contract allowed the seller to retain it as separate consideration. In Caplan v. Schroeder, 56 Cal. 2d 515, 364 P.2d 321, 15 Cal. Rptr. 145 (1961), the court struck down the notion that deposits could be retained as separate consideration for entering into the contract. The court held that the defendants executed the agreement, not in exchange for the down payment alone, “but in consideration of plaintiff’s agreement to purchase the property on all of the terms stated.” Id. at 517, 364 P.2d at 323, 15 Cal. Rptr. at 147. Thus, the court seemed to hold that disguising what amounted to a forfeiture in terms of “consideration” would not be tolerated. The Caplan court refused, however, to hold that liquidated damages clauses were invalid in all cases. The court adhered to the dicta in Freedman v. Rector, 37 Cal. 2d 16, 16, 230 P.2d 629, 629 (1951), and stated: “[A] provision for the retention of a reasonable down payment as liquidated damages in a contract for the sale of real property is presumptively valid.” Caplan v. Schroeder, 56 Cal. 2d 515, 518, 364 P.2d 321, 324, 15 Cal. Rptr. 145, 148 (1961).
rules. Even the careful drafter could not be assured of success.

The confusion involving liquidated damages provisions in real property sales contracts prompted commentators to advocate legislative reform of the entire liquidated damages area. In 1976 the California Law Revision Commission submitted a proposal designed to revamp California's existing law. This proposal was adopted by the legislature and passed in 1977. The law became effective on July 1, 1978.

**LEGISLATIVE HISTORY OF TITLE 4.5**

**The California Law Revision Commission's Recommendations**

In 1969, the California Legislature first authorized the California Law Revision Commission to study California's liquidated dam-

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75. In Cook v. King Manor and Convalescent Home, 40 Cal. App. 3d 782, 115 Cal. Rptr. 471 (1974), the seller was not allowed to retain payments made by the buyer because the seller offered no evidence as to the truth of the recitals in the clause dealing with the difficulty of determining actual damages and the reasonableness of the liquidated amount. However, the opinion reaffirmed the "presumption of validity" of liquidated damages clauses. The opinion seems to say that a buyer and a seller could validly liquidate the seller's damages when they truly agree that the damages will be difficult to estimate and when they attempt to project a reasonable amount in liquidation of the damages clause.

A 1976 case took a somewhat unique approach by analyzing liquidated damages provisions in terms of presumptions rather than as issues of substantive law. The court held that Civil Code § 1671 creates a rebuttable presumption of the reasonableness of the liquidated damages clause. The proponent was required to offer proof of (1) the agreement, (2) the impracticability of determining damages in the event of default, and (3) the reasonableness of the sum agreed upon. The court held that the presumption of validity did not arise until the above foundational facts were proven. United Sav. & Loan Ass'n Dev. Corp. v. Reeder, 57 Cal. App. 3d 282, 129 Cal. Rptr. 113 (1976).

78. The California Law Revision Commission was created in 1953. The Commission consists of one member of the Senate and one member of the Assembly, who constitute a joint investigating committee, and seven members appointed by the Governor with the advice and consent of the Senate. J. DRISCOLL, CALIFORNIA'S LEGISLATURE 132 (1976). The Commission was formed to examine the common law, the statutes of the state, and judicial decisions. The purpose of the Commission is to discover defects and anachronisms in the law and to recommend needed reforms. CAL. GOV'T CODE § 10330 (West 1976). At each regular session of the legislature, the Commission is required to report to the legislature on its studies and submit a list of topics to be studied. Before any topic is studied by the Commission, it must be approved by concurrent resolution adopted by the legislature. Id. § 10333.

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The Commission's task was to determine "whether the law relating to liquidated damages in contracts and, particularly, in leases, should be revised." Pursuant to its statutory authority, the Commission authorized a background study of the various aspects of liquidated damages.

After the publication of the background study, the Commission recommended innovative changes in California's liquidated damages laws. In substance, the 1975 recommendation proposed a statutory scheme designed to facilitate the use of liquidated damages clauses in most contracts. Under the proposed law, a stipulation of damages clause would be judicially enforced if agreed upon by parties in relatively equal bargaining positions. Further, the Commission proposed that any party seeking to invalidate the liquidated damages clause would have the burden of proving that it was unreasonable.

The Commission recognized that "[a] liquidated damages provision may serve several useful functions." The Commission concluded that liquidation clauses serve to avoid the cost, difficulty, and delay of proving damages in court and that the use of liquidated damages provisions curtail "troublesome problems involved in proving causation and foreseeability" if a contract is breached. The Commission felt that "[i]n many cases, the parties may feel that, if they agree on damages in advance, it is unlikely that either [party] will later dispute the amount of damages recoverable as a result of breach." The Commission determined

80. Id.
82. See Sweet, supra note 5, at 84.
84. The proposed new law would not be applicable in those situations in which parties of relatively unequal bargaining power were involved. For example, in consumer contracts the old law of Civil Code §§ 1670 and 1671 would continue to apply. This would provide protection for the significantly weaker and less experienced contracting consumer. 1975 Recommendation, supra note 83, at 2144.
85. Id. at 2146.
86. Id. "Reasonableness" is to be judged in light of the circumstances confronting the parties at the time of the making of the contract and not by the judgment of hindsight.
87. Id. at 2144.
88. Id.
89. Id.
90. Id.
that such clauses improve judicial administration and conserve judicial resources. "Enforcement of liquidated damages provisions will encourage greater use of such provisions and should result in fewer contract breaches, fewer law suits, and less extended trials."91

The Commission recognized, however, that the wholesale use of liquidated damages clauses could lead to occasional abuse. In the past liquidated damages clauses had been inserted in contracts by unscrupulous merchants to gain an advantage over consumers. "[T]he bulk of contracts today are various forms of adhesion contracts, the mass produced, nonnegotiated contracts pioneered by the insurance, utilities, and transportation industries."92 A liquidated damages clause in a consumer "adhesion" contract could trap the unwary and unsophisticated consumer. By using a liquidated damages clause in an adhesive fashion, the dominant party could

dictate the terms of the contract, if he is the performing party, he is likely to use the contract clause to limit his exposure almost to the vanishing point, and if he is the nonperforming party, he may try to use a penalty clause to coerce performance, or he may try to use a genuine liquidation clause to make vindication of his legal rights as convenient and inexpensive as possible. . . . In the event performance is not rendered, the clause may obtain a settlement or win the case.93

The abuse of liquidated damages provisions in consumer contracts94 led the Commission to recommend that the rule expressed in Civil Code sections 167095 and 167196 continue to apply in the consumer area. The recommendation rested on the notion that there was a need "to continue the protection now given to significantly weaker and less experienced contracting parties."97

Several features of the proposed new law dealt directly with the sale and leasing of real property.98 In the case of a lease of commercial real property, the Commission determined that no special rules were necessary. The general rule upholding the validity of a liquidated damages clause would apply, absent proof of its unreasonableness.99 However, the Commission took a different view

91. Id. at 2145.
92. Sweet, supra note 5, at 85.
93. Id. at 87.
94. The Commission defined "consumer contract" as "one for the retail purchase or rental by the consumer of personal property or services, primarily for personal, family, or household purposes, or the lease of residential real property." 1975 Recommendation, supra note 83, at 2146.
95. See note 11 for text of Civil Code § 1670.
96. See note 12 for text of Civil Code § 1671.
97. 1975 Recommendation, supra note 83, at 2146.
98. Id. at 2147.
99. Id.
when a lease of residential real property was involved. The Commission determined that

the existing restrictive provision of Sections 1670 and 1671 will continue to apply where a liquidated damages provision in a lease is sought to be enforced against a lessee of residential property and where a party seeking to invalidate a liquidated damages provision establishes that, at the time the lease was made, he was in a substantially inferior bargaining position.100

If land purchase contracts were involved, the Commission applied separate rules for residential and nonresidential real estate. In the case of nonresidential or commercial sales, the Commission recognized that parties may wish to include a provision liquidating damages.101 Such provisions would be upheld under the proposed statutory scheme.102 This reflected the Commission's view that clauses stipulating to damages should be valid where the parties are experienced and possess relatively equal bargaining power.103

The Commission adopted another set of standards for the sale and purchase of residential104 housing. These standards reflected the need for carefully drafted statutory limitations "to protect the defaulting buyer of residential housing against oppressive use of a liquidated damages provision."105 The proposed law recognized the validity of liquidated damages provisions but subjected them to safeguards.106 Such clauses would be valid only if all or part of

100. Id. This provision was added because of the Commission's desire to protect the unwary or unsophisticated consumer from overbearing lessors.

101. Id.

102. Id. The only restriction respecting commercial leases would be that they comport to reasonableness standards. The Commission did not define criteria for determining whether or not a liquidated damages clause was reasonable. It did state that reasonableness would be judged in light of the circumstances confronting the parties at the time of the making of the contract and that the party seeking to invalidate the contract would have the burden of showing that the provision was unreasonable.

103. Id. A recommendation was made requiring separate signing or initialing of liquidated damages clauses by the parties involved. Additionally, the Commission recommended that in printed contracts the liquidated damages clause should be set out in at least 10-point type or in contrasting red print in at least 8-point bold type. The initialing and size of type requirements would apply to both residential and nonresidential sales contracts.

104. Id. at 2148. The Commission defined residential housing as a dwelling consisting of not more than four residential units, one of which the buyer intends to occupy.

105. Id.

106. Id. The Commission stated: "This recommendation recognizes that in most cases even the unsophisticated buyer of residential housing expects that he will lose the deposit actually made if he does not go through with the deal." Id.
the buyer's payment was designated liquidated damages. Only the amount actually paid by the buyer could be considered valid liquidated damages even if the clause designated a larger amount.

The Commission added protections for the residential purchaser. Five percent of the purchase price was proposed as a ceiling for liquidated damages clauses in residential sales contracts. This standard protected the buyer from "forfeiting an unreasonably large amount as liquidated damages." The liquidated damages clause would be valid to the extent that it did not exceed five percent of the purchase price. However, even a clause liquidating damages at or below five percent would not be upheld if the buyer could establish that the provision was unreasonable under the circumstances existing when the contract was made.

Legislation Implementing the Recommendations

Assembly Bill 3169 was introduced in the 1975-76 regular session of the California Legislature. The bill paralleled the proposals of the Law Revision Commission. The bill was passed unanimously in 1976 in both the Assembly and the Senate. The bill was then forwarded to Governor Brown who vetoed the bill stating:

I see no justification for changing the law pertaining to liquidated damages clauses to favor the seller in contracts to purchase and sell real property. In cases where the value of real property is expected to increase and the seller will suffer no actual damages, automatic retention by the seller of any amount deposited by the defaulting buyer is unreasonable.

Governor Brown vetoed Assembly Bill 3169 apparently because the bill would have allowed sellers of residential real property to reap windfall profits. This is best illustrated by an example. A potential homebuyer, X, enters into a contract with seller, S, to

107. Id.
108. Id. The amount actually paid would include amounts paid in the form of cash or check, including postdated checks.
109. Id.
110. Id.
111. Id. If the liquidated damages provision exceeded five percent, the burden would be placed on the seller to establish its reasonableness under the circumstances existing at the time the contract was entered into. Id.
purchase a $100,000 home. The contract calls for liquidated damages in an amount equal to five percent of the total purchase price of the home.\textsuperscript{118} X pays $5,000 down on the home and then is unable to complete the transaction. Under Assembly Bill 3169, S is entitled to keep the $5,000 as liquidated damages, unless X can show that the provision was unreasonable when the contract was made.\textsuperscript{119} S may be able to retain the $5,000, place the home back on the market, and sell it later.

In a rising real estate market, such as California's, S will probably be able to dispose of the home at a price greater than the initial $100,000.\textsuperscript{120} Thus, S has not suffered any "real" damages. In fact, S has made a substantial profit. S' profits include X's $5,000 down payment as well as the profits resulting from the subsequent sale of the house. X is placed in a somewhat untenable position. If he tries to prove that the liquidated damages clause was unreasonable, he could not offer evidence of S' windfall profits from the subsequent sale of the home.\textsuperscript{121}

In 1977, Assembly Bill 570 was introduced.\textsuperscript{122} This bill substantially paralleled Assembly Bill 3169.\textsuperscript{123} However, changes were made to reflect Governor Brown's objections in his veto message of Assembly Bill 3169.\textsuperscript{124} The bill passed both houses of the legislature and was approved by the Governor in 1977.\textsuperscript{125} The difference between Assembly Bill 570 and its predecessor, Assembly Bill 3169, centers on contracts to purchase residential real prop-

\begin{itemize}
  \item \textsuperscript{118} 1975 Recommendation, supra note 83, at 2148. A.B. 3169 adopted the Commission's proposal that five percent of the purchase price of the home be the maximum that could be levied as liquidated damages. See A.B. 3169, Cal. Legis., 1975-76 Reg. Sess. (introduced on Feb. 23, 1976).
  \item \textsuperscript{119} A.B. 3169 does not delineate a standard of reasonableness. It does state that a determination of reasonableness is to be made based upon circumstances at the time the contract was entered into. The bill makes no provision for considering any subsequent sale of the dwelling. See A.B. 3169, Cal. Legis., 1975-76 Reg. Sess. (introduced on Feb. 23, 1976).
  \item \textsuperscript{120} 11 CAL. LEGIS., JOURNAL OF THE SENATE 19,443 (regular sess. 1975-1976).
  \item \textsuperscript{121} The most substantial changes were in the area of contracts to purchase residential real property.
\end{itemize}
erty. Assembly Bill 570, as passed, provides for a three percent of purchase price maximum for liquidated damages, compared to the five percent of purchase price maximum of Assembly Bill 3169. More importantly, Assembly Bill 570 provides specific standards for determining whether a liquidated damages provision is “reasonable.” Not only is reasonableness to be judged by the circumstances existing when the contract is made, thereby adopting the look-forward test announced in Better Foods Markets, but the court must also consider “the price, and other terms and circumstances of any subsequent sale or contract made within six months of the buyer’s default.” Both the three percent of purchase price maximum and the specific standards of “reasonableness” were added to limit windfall profits to the sellers of residential real property.

Although Assembly Bill 570 was passed in June, 1977, it did not become operative until July 1, 1978.129

**Ramifications of Title 4.5**

**The General Rule**

The new general rule for liquidated damages clauses is contained in California Civil Code section 1671. The new rule is

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127. See text accompanying notes 17-18 supra. See also A.B. 570, Cal. Legis., 1977-78 Reg. Sess. (introduced on Feb. 18, 1977). The provisions of the new law relating to “reasonableness” are codified in California Civil Code § 1675 subdivisions (c), (d), and (e). CAL. CIV. CODE § 1675 (c), (d), (e) (West Supp. 1978). The Comment to Civil Code § 1671 explains what is meant by “circumstances existing at the time the contract is made.” All the circumstances existing at the time of the making of the contract are considered, including the relationship that the damages provided in the contract bear to the range of harm that reasonably could be anticipated at the time of the making of the contract. Other relevant considerations in the determination of whether the amount of liquidated damages is high or so low as to be unreasonable include, but are not limited to, such matters as the relative equality of the bargaining power of the parties, whether the parties were represented by lawyers at the time the contract was made, the anticipation of the parties that proof of actual damages would be costly or inconvenient, the difficulty of proving causation and foreseeability, and whether the liquidated damages provision is included in a form contract. CAL. CIV. CODE § 1671, Comment (West Supp. 1978).


129. See CAL. CIV. CODE § 1671 (West Supp. 1978). This delay was to facilitate the printing of form contracts adaptable to the new legislation. 1976 Recommendation, supra note 77, at 1747.

130. Section 1671 provides:

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

(b) Except as provided in subdivision (c), a provision in a contract liqui-
that a contractual stipulation of damages is presumed valid unless the party seeking to invalidate the provision shows that it was unreasonable in light of the circumstances existing at the time the contract was made.\textsuperscript{131} The presumption of validity replaces the prior bias against liquidated damages provisions in section 1670 and judicial decisions.\textsuperscript{132}

Under the new provision, parties may agree to a reasonable liquidated damages provision with the assurance that the provision will be enforceable. In the event of breach, the party seeking to invalidate the clause has the burden of proving that the provision was unreasonable.\textsuperscript{133} Subdivision (b) of section 1671 limits the circumstances relevant to determining "reasonableness" to those in existence "at the time the contract was made."\textsuperscript{134} Among the relevant circumstances are: the relationship of the damages provided in the contract to the range of harm that reasonably could be anticipated; whether the amount of liquidated damages is so high or low as to be unreasonable; the equality of the bargaining power of the parties; whether the parties were represented by counsel when the contract was made; and whether the provision was included in a standard form contract.\textsuperscript{135}

Section 1671(a) states: "This section does not apply in any case where another statute expressly applicable to the contract dating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."\textsuperscript{136}

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

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

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

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

\begin{verbatim}
131. Id. § 1671(b).
132. See text accompanying notes 5-18 supra.
133. CAT. CIV. CODE § 1671(b) (West Supp. 1978).
134. Id.
135. Id. § 1671, Comment.
\end{verbatim}
prescribes the rules or standard for determining the validity of a provision in the contract liquidating the damages for the breach of the contract.\textsuperscript{136} This subdivision makes it clear that section 1671 does not affect other statutes governing liquidation of damages for certain types of contracts.\textsuperscript{137} For example, sales transactions under the Uniform Commercial Code are not affected by section 1671.\textsuperscript{138} Additionally, section 1671 is not applicable where the validity of the liquidated damages provision is governed by federal law or regulation.\textsuperscript{139}

The general rule of validity is in section 1671(b). However, the remainder of title 4.5, as passed in Assembly Bill 570, provides exceptions to, and qualifications of, the general rule. Treated separately are: real property purchase contracts,\textsuperscript{140} residential real property leases,\textsuperscript{141} consumer contracts for property or services,\textsuperscript{142} and public works construction contracts.\textsuperscript{143}

\textit{Specific Types of Contracts}

\textbf{Land Purchase and Sales Contracts}

The new law attempts to resolve the confusion surrounding the old rules.\textsuperscript{144} One objective of the new legislation was to develop "a new approach that would respect sellers' and buyers' intentions . . . in the absence of extreme inequality of bargaining power or an unreasonable stipulated amount."\textsuperscript{145} Such an approach was taken in order to allow the parties to "know where they stand at the time the contract is made and not be left to the uncertainty of the law in this area."\textsuperscript{146}

The new law provides two separate standards for the sale of real property. One standard governs the sale of residential real property while the other concerns sales of commercial or nonresidential property.\textsuperscript{147} Residential sales are subject to more restrictions on the use of liquidated damages clauses than

\begin{footnotes}
\item[136] \textit{Id.} § 1671(a).
\item[137] \textit{Id.}
\item[138] \textit{Id.} § 1671, Comment. Section 2718 of the California Commercial Code governs liquidated damages clauses in contracts for the sale of goods. \textit{CAL. COM. CODE} § 2718 (West 1976).
\item[139] \textit{CAL. CIV. CODE} § 1671, Comment (West Supp. 1978).
\item[140] See \textit{id.} §§ 1676, 1677, 1678 and text accompanying notes 149-94 infra.
\item[141] See \textit{CAL. CIV. CODE} § 1671(c) (2), (d) (West Supp. 1978) and text accompanying notes 203-18 infra.
\item[142] See \textit{CAL. CIV. CODE} § 1671(c) (1) (West Supp. 1978) and text accompanying notes 219-27 infra.
\item[143] See \textit{CAL. GOV'T CODE} § 53069.85 (West Supp. 1978).
\item[144] See text accompanying notes 53-77 supra.
\item[145] Sweet, \textit{supra} note 5, at 100.
\item[146] \textit{Id.}
\item[147] \textit{Compare CAL. CIV. CODE} § 1675 (West Supp. 1978), with \textit{id.} § 1676.
\end{footnotes}
nonresidential sales. This disparity reflects the notion that consumers with less bargaining power require more protection in the marketplace. Commercial vendors generally can bargain at arm’s length and thus require less protection.  

Nonresidential Sales

The rules governing the sale of nonresidential real property allow party autonomy in the use of the liquidated damages clause. Among the benefits anticipated by the liberal use of liquidated damages clauses are: fewer contract breaches, fewer lawsuits, less extended trials, improvement of judicial administration, and conservation of judicial resources.  The new rules are found in Civil Code sections 1676, 1677, and 1671 subdivision (b).  Section 1676 establishes the general validity of the liquidated damages provisions; section 1677 prescribes procedural formalities which must be met; and section 1671 (b) provides a test of “reasonableness” to be employed if a party later attempts to invalidate the liquidated damages provision.

148. See 1976 Recommendation, supra note 77, at 1721.
149. Civil Code § 1675(a) defines residential property as “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.” CAL. CIV. CODE § 1675(a)(1), (2) (West Supp. 1978).
It can be assumed that any property which does not meet the requirements of Civil Code § 1675(a) can properly be classified as nonresidential.
150. 1976 Recommendation, supra note 77, at 1741.
151. Section 1676 provides for the general validity of liquidated damages clauses in nonresidential sales contracts. It reads:

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 complete the purchase of the property is valid if it satisfies the requirements of Section 1677 and the requirements of subdivision (b) of Section 1671.


Section 1677 provides for the formal requirements of a written contract which employs a liquidated damages clause. It reads:

A provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to complete the purchase of the property is invalid unless:
(a) The provision is separately signed or initialed by each party to the contract; and
(b) If the provision is included in a printed contract, it is set out either in at least 10-point bold type or in contrasting red print in at least eight-point bold type.

Id. § 1677.

152. Id. §§ 1676, 1677, 1671(b).
Section 1676 of the Civil Code provides that a liquidated damages clause in a contract to purchase and sell real property "is valid" if it meets certain requirements. To be valid, the liquidated damages provision must be separately signed or initialed by the parties. If printed, the contract must meet certain type-size requirements. These two requirements are designed to assure a contract that has been freely negotiated by the parties.

Civil Code section 1676 creates a rebuttable presumption that a liquidated damages provision in a nonresidential real estate purchase and sales contract is valid. To rebut the presumption, one must show that "the provision was unreasonable under the circumstances existing at the time the contract was made." Accordingly, the amount of actual damages has no bearing on the validity of the provision. The Law Revision Commission Comment accompanying section 1671(b) of the Civil Code points out that all the circumstances existing at the time of the making of the contract are considered in determining the clause's validity.

An illustration will demonstrate how the new statute operates. Assume that landowner X and real estate developer Y enter into a contract whereby Y is to purchase from X ten acres of land to

153. The new law applies only to contracts entered into after July 1, 1978. The Code section applies only to the situation where the buyer has failed to complete the purchase of the property. Id. § 1676. Section 1676 does not apply to real property sales contracts as defined in Civil Code § 2985. Section 2985 deals with installment land contracts, and no change has been made in the law that governs the extent to which payments made pursuant to such contracts may be forfeited upon the buyer's default. See id. §§ 1681, 2985.

154. Id. § 1671. When the provision is set out in a written contract, it must be set out either in at least 10-point type or in contrasting red print in at least eight-point bold type. Id.

155. Id. § 1677.

156. Id. § 1676. Under the old rule the party relying on the liquidated damages provision had the burden of proving its validity. See, e.g., Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal. 2d 179, 253 P.2d 10 (1953).

157. Id. § 1671(b). For a contrary rule, see CAL. COM. CODE § 2718 (West 1976) (damages may be liquidated at an amount which is reasonable in the light of anticipated or actual harm) and CAL. CIV. CODE § 1875(e)(2) (West Supp. 1978) (subsequent sale as bearing on reasonableness of provision liquidating damages to seller in case of default by buyer of residential property).

158. CAL. CIV. CODE § 1671(b), Comment (West Supp. 1978). Among those factors to be considered are:

The relationship that the damages provided in the contract bear to the range of harm that reasonably could be anticipated at the time of the making of the contract . . . whether the amount of liquidated damages is so high or so low as to be unreasonable . . . the relative equality of the bargaining power of the parties, whether the parties were represented by lawyers at the time the contract was made, the anticipation of the parties that proof of actual damages would be costly or inconvenient, the difficulty of proving causation and foreseeability, and whether the liquidated damages provision is included in a form contract. Id.
be used in a development project. The agreed price is $100,000. Before signing the contract, the parties engage in extensive negotiations. Through their respective attorneys, the parties agree that $5,000 is to be deposited into escrow by Y. The $5,000 represents liquidated damages payable to X if escrow does not close within ninety days. At the time of negotiations the parties do not anticipate any actual damages in the event of buyer Y's breach; negotiations take place when land prices are rising. They do, however, agree that X should be compensated for any time lost or inconvenience to him resulting from a breach of contract by Y. Assume further that escrow does not close during the required time period because of Y's willful breach and that one month after escrow was to close, X sells the property to someone else for $105,000.

Under the new section 1676 of the Civil Code, the court should uphold the validity of the liquidated damages provision even though X reaped a windfall profit of $5,000. Under section 1671(b) of the Civil Code, Y would have the burden of proving that the contract was unreasonable when it was executed. The facts of the illustration, however, do not indicate that the contract was "unreasonable" within the meaning of the statute. X and Y negotiated at arm's length, and each knew what he was doing when the contract was formed. The agreed damages, $5,000, represent five percent of the purchase price which is not so "high . . . as to be unreasonable." Additionally, the court should not look to the subsequent sale at a higher price as evidence that the agreement between X and Y was unreasonable. The validity of the provision is determined at the time the contract was made, not retrospectively. The court, therefore, should not employ the benefit of hindsight to declare the provision unreasonable. The clause was negotiated, the risk of forfeiture of the escrow money was assumed by the buyer, and the stipulated amount was reasonable in light of the circumstances when the contract was made.

The general validity provision of section 1676 contrasts sharply with the prior law. Under the old rules, a party seeking to enforce the clause was required to prove that when the contract was

160. Id.
161. Id.
162. Id. § 1671.
made it would have been impracticable or extremely difficult to fix the actual damages in case of a later breach. However, as the discussion above indicates, the standards under the old law were not easily met.

**Residential Sales**

Under the new law, different standards test the validity of liquidated damages provisions in contracts for the sale of residential real property as opposed to contracts for the sale of nonresidential real property. Rather than give the parties unlimited autonomy to use liquidated damages provisions, the legislature has provided "a simple formula that will enable the seller to keep the deposit or some designated lesser amount" in the event that the buyer breaches. Less freedom is given because of the legislature's concern that there is the risk that a liquidated damages provision will be used oppressively by a party able to dictate the terms of an agreement. And there is the risk that such a provision may be used unfairly against a party who does not fully appreciate the effect of the provision.

Residential sales are now governed by sections 1675, 1677, and 1678 of the Civil Code. Section 1675 details the basic provisions respecting liquidated damages clauses in residential sales contracts, section 1677 prescribes procedural formalities, and section 1678 governs multiple payments under a liquidated damages clause.

Residential property is defined as a dwelling containing not more than four residential units. When entering into the contract, the purchaser must intend to occupy at least one unit as his residence. If the dwelling is larger than four units or the purchaser has no intent to occupy at least one unit, the contract becomes one for the sale of nonresidential property and is governed by sections 1676 and 1671(b) of the Civil Code.

Section 1675 of the Civil Code establishes the validity of the liquidated damages clause in a residential real property sales con-
A clause in which the parties agree that payments by the buyer constitute liquidated damages for the buyer's default is valid only to the extent that the buyer has actually made payments. For example, if the contract calls for the buyer to deposit $1,000 into escrow, that sum represents liquidated damages if the buyer defaults. If the buyer deposits only $500 and later defaults, the seller will be able to recover only the $500 actually deposited, even though the contract called for a larger liquidated amount. However, if the buyer had deposited $1,500 into escrow before his default, the seller would not be able to retain more than the $1,000 bargained for. Under the new rules, the court should not allow the seller to recover damages greater than the amount specified in the liquidated damages provision.

The new law imposes a ceiling on the amount the seller can recover as liquidated damages. Section 1675 of the Civil Code uses three percent of the purchase price as a standard to measure the reasonableness of the liquidated damages provision. The burden of proof as to reasonableness is allocated depending on whether the agreed sum is greater or less than three percent of the purchase price. If the amount does not exceed three percent, the party seeking to invalidate the provision has the burden of establishing that the provision was unreasonable. Conversely, if the amount exceeds three percent, the party seeking to enforce the provision has the burden of establishing that the additional amount was reasonable.

Reasonableness of the agreed liquidated sum is determined by

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174. Id. § 1675, Comment. Section 1675 establishes certain guidelines for determining the validity of the liquidated damages clause. The new provisions were promulgated with two considerations in mind: 1) in most cases even an unsophisticated buyer of residential housing expects that he will lose the deposit actually made if he does not go through with the deal, and 2) a residential purchaser should still be protected from forfeiting an unreasonably large amount as liquidated damages. Id.

175. Id. § 1675(b).

176. Payment may be made in the form of cash or check, including a postdated check. Id.

177. Compare id. § 1675(c), with id. § 1675(d).

178. Id § 1675.

179. Id.

180. Id. These provisions provide protection to the buyer as well as to the seller. A buyer may seek to uphold a liquidated damages provision when the amount paid is three percent or more of the purchase price, in order to limit his liability when the seller is able to show higher actual damages. See id. § 1675, Comment.
the circumstances existing when the contract was entered into. However, a court also must consider the "price and other terms and circumstances of any subsequent sale or contract to sell . . . the same property if such sale or contract is made within six months of the buyer's default." The latter provision was included to prevent a seller from reaping windfall profits in a rising real estate market. For example, assume buyer agrees to buy a home for $100,000. The parties agree that three percent ($3,000) of the purchase price will represent liquidated damages. Buyer breaches the contract in sixty days. In a rising real estate market, seller should be able to place the home back on the market and receive more than the $100,000 called for in the original contract. The legislature determined that it would be unfair for the seller to retain both the entire liquidated sum bargained for in the initial contract and the profit made on the subsequent sale.

In a "subsequent sale" situation, the court will consider the circumstances surrounding the subsequent sale. Of particular interest are the price and terms of the subsequent sale itself, as well as the cost of taxes, interest, insurance, and any additional broker fees incurred as a result of the buyer's breach.

Section 1677 of the Civil Code details the formal requirements for liquidated damages clauses in residential sales contracts. The provision must be separately signed or initialed by each party to the contract. If the provision is included in a printed contract, it must be set out either in ten-point bold type or in contrasting red print in at least eight-point bold type. The formal requirements help to insure that the parties will appreciate the consequences of including a liquidated damages clause in the contract.

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181. Id. § 1675(e) (1). "Reasonableness" will be determined by the following: the relationship that the damages provided in the contract bear to the range of harm that reasonably could be anticipated at the time of the making of the contract . . . whether the amount of liquidated damages is so high or so low as to be unreasonable, . . . the relative equality of the bargaining power of the parties, . . . whether the parties were represented by lawyers, . . . the anticipation of the parties that proof of actual damages would be costly or inconvenient, the difficulty of proving causation and foreseeability, and whether the liquidated damages provision is included in a form contract.

182. Id. § 1671, Comment.

183. Id. § 1675(e) (2).

184. 1976 Recommendation, supra note 77, at 1745.

185. CAL. CIV. CODE § 1675(e) (2) (West Supp. 1978).

186. Id. § 1675, Comment.

187. Id. § 1677.

188. Id. § 1677(a).

189. This provision is similar to many other recently enacted statutes designed to protect consumers. See, e.g., id. § 2904.1 (contract provision respecting insur-
Section 1678 of the Civil Code outlines additional formal requirements. Frequently a deposit is given when the agreement to sell and to purchase the property is made, and a second payment is made when escrow opens. Under section 1678 the payment made at the time escrow is opened can be retained by the seller as liquidated damages only if: (1) there is a valid agreement between the parties that the separate payment may constitute liquidated damages in case of breach, and (2) there is a separate signing or initialing by each party for the subsequent payment. The underlying purpose of this section is similar to that of Civil Code section 1677; that is, to protect the buyer by insuring that he will appreciate the consequences arising under the liquidated damages clause.

Prior to section 1671 of the Civil Code, neither party could be sure that a liquidated damages provision in a residential sales contract would be enforced by the courts. Section 1675 announces a specific formula to determine whether the liquidated damages provision in a residential sales contract is valid. This formula should remove some of the uncertainty which surrounded the old law.

Real Property Leases

Section 1671 of the Civil Code provides two standards for determining the validity of a liquidated damages clause in a real property lease. One standard applies to the lease of a residential dwelling and the other applies to all other real property leases. On the one hand, the legislature wanted to give parties bargaining at arm’s length the right to control the amount of damages in the case of breach. On the other hand, it wanted to protect consumers against the oppressive use of the liquidated damages clause. The Commission feared the dominant party’s ability to

190. 1976 Recommendation, supra note 77, at 1745.
192. See text accompanying notes 186-89 supra.
193. For a discussion of the uncertainty surrounding the enforceability of a liquidated damages provision, see text accompanying notes 79-103 supra.
194. For a discussion of the formula to be applied, see text accompanying notes 177-80 supra.
195. Compare CAL. CIV. CODE § 1671(b) (West Supp. 1978), with id. § 1671(c)(2), (d).
196. 1976 Recommendation, supra note 77, at 1741.
dictate the terms of an agreement and incorporate an unfair liquidating provision. The public policy that liquidated damages clauses should be limited to those situations in which the parties have substantially equal bargaining power pervades the new legislation.197

Nonresidential Leases

Nonresidential leases are governed by section 1671(b) of the Civil Code.198 The general presumption is that a liquidation clause is valid.199 A party seeking to invalidate a liquidation clause in a nonresidential lease has the burden of proving the clause unreasonable.200

The new law distinguishes between a true liquidated damages clause and a deposit used to secure the payment of actual damages in case of a breach. Instead of promising to pay a fixed sum as liquidated damages,201 the lessee may provide a deposit as security for his performance. If the parties intend that the deposit shall be liquidated damages for a breach of the contract, the validity of the clause is determined under section 1671(b). However, if the parties do not intend that the deposit shall constitute liquidated damages in the event of a breach, the deposit is merely a fund to secure the payment of actual damages if any are found. Deposits to secure payment of actual damages are covered in Civil Code section 1950.7.202

Residential Leases

Liquidated damages provisions in leases of residential dwellings are controlled by Civil Code section 1671(d)203 when the pro-

197. Id.
198. For text of Civil Code § 1671(b), see note 130 supra.
199. See text accompanying notes 130-35 supra.
200. For a discussion of the circumstances considered in determining "reasonableness," see text accompanying notes 134-35 supra. In nonresidential leases, the burden of proof on the issue of reasonableness is on the party attempting to have the liquidated damages provision invalidated. CAL. CIV. CODE § 1671(b) (West Supp. 1978). As in the sale of nonresidential real property, "reasonableness" in a nonresidential lease is determined by looking at the circumstances as they existed at the time the contract was entered into. Id.
201. See CAL. CIV. CODE § 1671(b), Comment (West Supp. 1978).
202. Section 1950.7 deals only with nonresidential leases. It provides that the landlord may retain such deposits only to the extent reasonably necessary to remedy tenant defaults in the payment of rent, to repair damages to the premises caused by the tenant, or to clean the premises upon termination of the tenancy. It provides further that the remaining portion of any deposit must be returned to the tenant after termination of his tenancy. Id. § 1950.7.
203. Section 1671(d) provides:

[A] provision in a contract liquidating damages for the breach of the contract is void except that the parties to such a contract may agree therein
vision is sought to be enforced against a residential lessee.\textsuperscript{204} Section 1671(d) embodies the "old" liquidated damages law in former Code sections 1670\textsuperscript{205} and 1671.\textsuperscript{206} Under the present section 1671(d), the liquidated damages provision is void unless it is established that: (1) the parties agreed on the liquidated sum\textsuperscript{207} and (2) the actual damages would be "impracticable or extremely difficult" to fix in the event of breach.\textsuperscript{208} Unlike other areas covered by the new law,\textsuperscript{209} the revisions made in the residential lease area do not alter the substance of former sections 1670 and 1671.\textsuperscript{210}

One explanation for the retention of the "old law" in residential leases may be that the legislature determined that other Civil Code sections adequately dealt with the problem in most instances. Until 1970, most litigation in the area revolved around "the right of a landlord to retain advance deposits upon a tenant breach, without regard to actual damages."\textsuperscript{211} In 1970, the legislature passed Civil Code section 1950.5 dealing with the retention of the lessee's deposit by the lessor.\textsuperscript{212} Apparently, section 1950.5 has resolved many of the problems concerning the retention of such deposits.\textsuperscript{213}

Section 1950.5 is not applicable to all situations. In some instances a "true" liquidating provision is needed to adequately establish damages in the event of breach.\textsuperscript{214} Section 1671(d) allows upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

\textit{Id.} § 1671(d).

204. If the party seeking to avoid the liquidated damages provision is the non-consumer party, subdivision (b) of § 1671 is applicable. \textit{See id.} § 1671(b).

205. For a discussion and the text of Civil Code § 1670, prior to its repeal, see text accompanying notes 11-15 \textit{supra}.

206. \textit{See text accompanying notes 11-16 \textit{supra}.}


208. \textit{Id.}

209. For a discussion of the applicable law in other areas of liquidated damages clauses, see text accompanying notes 168-94 \textit{supra} (sale of residential real property); \textit{id.} notes 149-65 \textit{supra} (nonresidential real property); \textit{id.} notes 195-202 \textit{supra} (nonresidential leases).


211. Sweet, \textit{supra} note 5, at 100.

212. Section 1950.5 was amended in 1977. However, its provisions remain substantially intact. The section provides that a landlord may retain advanced payments made by the lessee only to the extent reasonably necessary to remedy any default by the tenant. \textit{CAL. Civ. CODE} § 1950.5 (West Supp. 1978).

213. For a case illustrating how the courts resolve some of the issues, see Bauman v. Islay, Inc., 30 Cal. App. 3d 752, 106 Cal. Rptr. 889 (1973).

214. In Sweet's background study, he gives the example of a situation in which
the parties to create a liquidated damages clause in the lease. The clause must conform to the test of section 1671(d). That is, it must be shown that actual damages would be "impracticable or extremely difficult to fix"215 in the event of breach. However, the practicality and utility of the above tests are suspect. Sweet, in his background study,216 described the test as being "so ambiguous [that] it fails to provide guidance to [the] contracting parties."217 Yet the Law Revision Commission's recommendation relating to change in the area of leases stated: "[N]o special rules applicable to real property leases are necessary . . . ."218 Because of the ambiguous nature of the test, case law must be consulted to determine the future enforceability of the liquidating clause in the residential lease area.

Consumer Contracts

Subsection (d) of Civil Code section 1671 applies when liquidated damages are sought from a consumer.219 Under subsection (d), a liquidating clause in a consumer contract is presumed invalid absent exceptional circumstances.220 The Code defines a consumer contract as one for the "retail purchase, or rental . . . of personal property or services, primarily for . . . personal, family or household purposes."221

The restrictive provisions of subsection (d) apply in consumer cases because of the realization that the bulk of consumer contracts are contracts of adhesion.222 In an adhesion contract, the party in the weaker bargaining position (almost always the consumer) has no leverage in negotiating the liquidated damages clause.223 The less restrictive provisions of subsection (b) of section 1671 are intended to apply only if the two parties possess relatively equal bargaining power and are able to freely negotiate a mutually acceptable agreement.224 Because a true bargaining

there is a breach of a covenant to return or vacate the rented property. Sweet, supra note 5, at 104.

216. Sweet, supra note 5, at 142.
217. Id.
218. 1976 Recommendation, supra note 77, at 1743.
219. CAL. CIV. CODE § 1671(d) (West Supp. 1978). For text of subsection (d), see note 130 supra.
220. CAL. CIV. CODE § 1671(d) (West Supp. 1978). Exceptional circumstances arise when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damages. Id.
221. Id. § 1671(c)(1).
222. See Sweet, supra note 5, at 85.
223. Id.
224. CAL. CIV. CODE § 1671(b) (West Supp. 1978).
process does not exist in a consumer contract,\textsuperscript{225} the legislature has attempted to protect the consumer by restricting the use of the liquidated damages clause in consumer contracts. In his background study, Sweet summarized the situation:

\begin{quote}
[I]n adhesion transactions there is a great risk of oppression and abuse of autonomy. Since there is no bargaining process we should not accord even prima facie reasonableness to the amount selected. . . . Moreover, in this situation the clause should be enforced only if the court needs help in establishing the amount of damages,\textsuperscript{226}
\end{quote}

It is impossible to predict what effect the restrictive provisions of section 1671(d) will have on consumer contracts. The standards of subsection (d) provide no real guidelines for parties who wish to include a liquidating provision.\textsuperscript{227} However, one would hope that courts will apply section 1671(d) with an eye toward protecting the consumer from those in superior bargaining positions.

**Construction Contracts**

Liquidated damages clauses contained in private construction contracts are now governed by section 1671. The general rule of validity applies\textsuperscript{228} and the clause will be enforceable unless it is shown to be unreasonable.\textsuperscript{229} Only those circumstances existing when the contract was executed bear on the issue of “reasonableness.”\textsuperscript{230}

Section 1671 gives the parties to a construction contract considerable leeway in determining damages in the event of breach. The presumption of validity accompanying section 1671 should resolve many of the ambiguities surrounding liquidated damages clauses in construction contracts.\textsuperscript{231} The new law makes no distinction between owner and contractor breaches. Therefore, liquidated damages clauses will be enforced both for the owner’s failure to pay the contract price and for the contractor’s late or nonperformance.\textsuperscript{232} Additionally, actual damages suffered will be irrelevant in a court’s determination of the “reasonableness” of

\textsuperscript{225} See Sweet, supra note 5, at 85.
\textsuperscript{226} Id. at 144.
\textsuperscript{227} See text accompanying notes 216-17 supra.
\textsuperscript{228} See CAL. CIV. CODE § 1671(b) (West Supp. 1978).
\textsuperscript{229} Id.
\textsuperscript{230} Id. For a listing of circumstances taken into consideration, see text accompanying note 135 supra.
\textsuperscript{231} See text accompanying notes 25-33 supra.
\textsuperscript{232} See CAL. CIV. CODE § 1671(b) (West Supp. 1978).
the liquidating clause.\textsuperscript{233}

The new law sets up a slightly different standard when a public works type of construction contract is entered into between a private contractor and a governmental agency. Public works contracts do not fall under the auspices of Civil Code section 1671 because the general provisions of that section are not applicable where another statute provides a standard for determining the validity of the liquidated damages clause.\textsuperscript{234}

Section 53069.85 of the Government Code now specifically grants the legislative body of a city, county, or district the right to include a liquidated damages clause in contracts for public projects.\textsuperscript{235} The clauses may provide that for each day that completion of a project is delayed beyond a specified time, the contractor shall be liable for liquidated damages.\textsuperscript{236} Although section 53069.85 allows discretionary inclusion of the liquidated damages clause by local governmental agencies, all construction contracts entered into by California state agencies must include such a clause.\textsuperscript{237} The new law also allows the state, as well as local agencies, to include bonus provisions in the contract. A bonus provides for the payment of extra compensation to the contractor in the event that the construction is completed early.\textsuperscript{238}

In public works construction contracts, the sum specified as liquidated damages is valid unless "manifestly unreasonable" under the circumstances existing when the contract was made.\textsuperscript{239} This standard of "reasonableness" is somewhat different from the standard used under Civil Code section 1671.\textsuperscript{240}

The relative certainty of the new law allows the parties to include clauses providing for truly adequate damages in case of a breach. This should remedy the situation as it existed in the past. Often the parties would agree on a clause which they felt adequately compensated the nonbreaching party in case of the other's nonperformance, only to find the clause struck down by an unreceptive court.\textsuperscript{241}

\textbf{Ambiguities in Title 4.5}

Title 4.5 is a welcome attempt to clarify liquidated damages law.

\begin{itemize}
  \item \textsuperscript{233} \textit{Id.} § 1671, Comment.
  \item \textsuperscript{234} \textit{Id.} § 1671(a).
  \item \textsuperscript{235} \textit{Cal. Gov't Code} § 53069.85 (West Supp. 1978).
  \item \textsuperscript{236} \textit{Id.}
  \item \textsuperscript{237} \textit{Id.} § 14376.
  \item \textsuperscript{238} \textit{See id.} §§ 53069.85, 14376.
  \item \textsuperscript{239} \textit{Id.} § 53069.85.
  \item \textsuperscript{240} \textit{See Cal. Civ. Code} § 1671(b) (West Supp. 1978).
  \item \textsuperscript{241} \textit{See Sweet, supra} note 5, at 117.
\end{itemize}
The case law in this area during the 105 years before the enactment of title 4.5 was ambiguous. The enforceability of liquidation clauses varied in as many ways as there were subjects to support contracts with such clauses. This section attempts to identify the ambiguities in this title.

Throughout the legislative history of title 4.5, the drafters emphasized the major change in the newly promulgated statute: a new norm that damages clauses would be judicially enforced if agreed upon by parties of relatively equal bargaining power. The old presumption of invalidity was replaced by a presumption of validity.

The Commission realized that "the bulk of contracts today are various forms of adhesion contracts, the mass produced, nonnegotiuated contracts pioneered by the insurance, utilities, and transportation industries." However, all discussion of adhesion contracts is limited to the legislative history of title 4.5. Civil Code section 1671(b) does not expressly limit the presumption of validity to contracts between parties of equal bargaining power. Thus, the possibility exists that all contracts (adhesion as well as those between equal bargaining parties) will be construed in the light of the presumption of validity. This omission by the drafters of title 4.5 invites controversy where none need exist.

Admittedly, Civil Code section 1671(c) and (d) provides an exception to the presumption of validity for consumer contracts. However, adhesion contracts are not limited to the field of consumer transactions. Adhesion contracts permeate all areas of contractual relations. The exception to the presumption of validity in consumer contracts does not go far enough to effectuate the intent of the drafters in discouraging liquidation clauses in adhesion contracts.

Civil Code section 1671(a), limiting the presumption of validity to contracts not governed by any other statute, compounds the confusion. The express statutory exceptions to section 1671(b)

\[\text{References:}\]
242. *Id.* at 90-131.
243. *See* text accompanying notes 130-32 *supra*.
244. *Id*.
245. *Sweet, supra* note 5, at 141.
247. *Id.* § 1671(b).
248. *Id.* § 1671, Comment.
249. *Id.* § 1671(a), Comment.
create an inference that section 1671(b) governs all other contracts regardless of whether the contract is one of adhesion or between parties of equal bargaining power. A simple amendment to section 1671(b) that a contract liquidating the damages for a breach of the contract between parties of equal bargaining power is valid would effectuate the drafter’s intent to limit the presumption of validity to contracts between parties of equal bargaining power.

Government Code section 53069.85 is a second area of potential ambiguity. This section invalidates “manifestly unreasonable” liquidation clauses. The Government Code provides no guides for determining whether a liquidation clause is “manifestly unreasonable.”

Whether Civil Code section 1671(b)’s standards will be used to construe manifest unreasonableness is unknown. Unlike Civil Code section 1671, the Government Code provides no clue as to how “manifestly unreasonable” is to be interpreted. However, the term implies that a person seeking to invalidate the clause would have a greater burden of proving “unreasonableness” than would a person attacking a clause under the rules of section 1671. Such an interpretation of “manifestly unreasonable” is consistent with past judicial decisions in the liquidated damages area. Traditionally, liquidated damages clauses in public works construction contracts have been enforced, even though similar clauses in other types of contracts have not. Judicial opinions in the future will, no doubt, provide insight into the meaning of “manifestly unreasonable.”

Third, the Better Foods Markets look-forward test was adopted by title 4.5 in determining the reasonableness of a liquidation clause. However, Civil Code section 1675 looks to the reasonableness of the amount actually paid and not to the reasonableness of the clause. In residential sales contracts the “price and other terms and circumstances of any subsequent sale or

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251. Id.
252. Id.
253. See Sweet, supra note 5, at 121.
254. Factors currently used in determining Civil Code § 1671(b) reasonableness are: (1) the relationship that the damages stipulated in the contract bear to the range of harm that reasonably could be anticipated (look-forward test), (2) whether the amount of liquidated damages is so high or so low as to be unreasonable, (3) the equality of the bargaining power of the parties, (4) whether the parties were represented by lawyers at the time of the formation of the contract, and (5) whether or not the liquidation clause is in a form contract. See text accompanying notes 133-35 supra.
255. See note 18 supra.
contract to sell . . . the same property if sale or contract is made within six months of the buyer's default" are also considered in determining reasonableness.\textsuperscript{257}

As stated earlier, the look-forward test is designed to ascertain reasonableness in the light of circumstances at the time the contract was formed. On the other hand, the "subsequent sale" test looks to the circumstances after the breach of the contract by the buyer. The potential conflict between the tests' perspectives is clear. One test looks at circumstances before the breach and the other looks at circumstances after the breach, yet they are to be used conjunctively in determining the reasonableness of the liquidated clause.

However, the inconsistency apparent in the application of the two tests is not fatal to the purpose of the legislation. The consumer is protected if either or both of the tests are applied. When using the look-forward approach, the court will be able to consider any factors pointing to overbearance at the time the contract was signed. If there has been a "subsequent sale," the court will be able to determine whether or not the seller has reaped windfall profits. If both tests are properly applied by the courts, consumers will not be forced to pay unreasonable sums of money as liquidated damages.

\section*{Conclusion}

The new liquidated damages law will provide more certainty in an area which was fraught with confusion in the past. In most instances, parties will be able to negotiate a liquidated damages clause with the assurance that the provision will be enforced in the event of a breach. In the past, courts have resorted to legal fictions, such as alternative performance, to enforce some liquidation clauses. As a result of the new legislation, the courts will now be able to rely on identifiable standards when considering the validity of the liquidating clause. However, title 4.5 is not a panacea. Ambiguities still exist. The drafters of the new legislation failed to differentiate expressly between contracts of adhesion and contracts between parties of equal bargaining power. Additionally, in the area of government contracts, the drafters failed to give practitioners any guides for determining whether a

\begin{footnotesize}
\textsuperscript{257} \textbf{Compare} \textit{CAL. CIV. CODE} § 1675(e)(1) (West Supp. 1978), \textit{with id.} § 1675(e)(2).
\end{footnotesize}
liquidation clause is “manifestly unreasonable.” Finally, the standards for determining “reasonableness” in residential sales contracts appear inconsistent. Besides adopting the look-forward test of Civil Code section 1671, the drafters have also added a second “subsequent sale” test, which requires the courts to look to any subsequent sale by the seller to determine whether he has suffered any actual damages.

The purpose underlying the new legislation is to promote party autonomy and avoid the cost, delay, and difficulty of proving damages in court. At this time, one can only speculate as to whether these policies will be met. Title 4.5 may eliminate litigation over the question of whether a liquidated damages clause may be included in specific contracts. However, the general issue of whether the contract is one of adhesion and more specifically whether the liquidation clause is “reasonable” may promote litigation.

The business trend toward efficiency and mass production increases the use of adhesion contracts. Party autonomy in creating a contract is quickly dying. Title 4.5 is an admirable effort to clarify liquidated damages law and expedite judicial enforcement. However, the legislature and the courts should be careful to differentiate between adhesion contracts and contracts between parties of equal bargaining power. Justice in enforcing liquidation clauses should not bow to expediency in court administration.

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