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#### **What Are Liquidated Damages in California?**

Liquidated damages are referred to damages for breach of contract, except in consumer goods and certain real property transactions, determined in advance by parties to the contract. However, in California liquidated damages are unenforceable if they do not bear a reasonable relationship to the actual amount of damages that the parties could have anticipated to flow from a breach. In this article, we briefly explore the enforceability of such damages.

#### **Unenforceability of Liquidated Damages, If Deemed Penalty or Forfeiture**

The amount established as liquidated damages "must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. In the absence of such relationship, a contractual clause purporting to predetermine damages 'must be construed as a penalty.'" *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977 (citations omitted). See also *Jade Fashion & Co., Inc. v Harkham Indus., Inc.* (2014) 229 CA4th 635, 646 (discount provision was not unenforceable penalty or forfeiture).

In *Ridgley*, the loan agreement at issue required the borrowers to pay the lender a prepayment fee equal to 6 months' interest when the real property collateral was sold if the borrowers had been more than 15 days late with any scheduled interest payment (or had defaulted on any other contract provision). The borrowers sold the property before the loan matured, and repaid the loan principal along with the prepayment fee on the lender's demand (the borrowers had been late with one interest payment). The court held that the prepayment fee clause was a penalty and was unenforceable because it bore no relationship

to the potential damages that the lender would incur from a late interest payment. Under the clause, any late interest payment would result in a severe penalty—the borrowers' inability to sell the property without payment of a significant predetermined amount. Unlike conventional prepayment fee clauses, the purpose of this provision was to coerce timely payment of interest, not to compensate the lender for interest payments lost through prepayment of principal.

*Cal. Civil Code of Proc. Section 3275* reflects the equitable rule against forfeitures by providing relief from forfeiture even if the party seeking relief has breached the contract:

“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.”

Under §3275, any contractual provision by which money or property could be forfeited regardless of the actual damage suffered may be unenforceable as a penalty. If a liquidated damages clause is found to be a penalty, the party that has suffered damage may collect only the amount of actual damages it has sustained. *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977.

### **A Possible Solution**

One way to avoid enforcement issues concerning a liquidated damages clause is to provide for a true alternative performance. In *Ridgley* (17 C4th at 978) the California Supreme Court noted that, in general, contractual charges for prepayment of loan principal are deemed to be valid provisions for alternative performance, rather than liquidated damages or penalties for breach. Repayment of a loan before maturity is not a breach of the loan agreement, but simply an alternative mode of performance by the borrower. For that reason, the prepayment charge is not a penalty imposed for default, but instead an agreed form of compensation to the lender for interest lost through prepayment.

### **DISCLAIMER:**

This article NEITHER supplants NOR supplements the breadth or depth of such rarefied topic. In fact, this article ONLY provides a rudimentary synopsis of such esoteric subject matter.

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