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Built-In Contract Remedies: Avoiding the Unenforceable Penalty

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Under California law, a provision of a contract found to impose a penalty is unenforceable as a forfeiture and contrary to public policy. The characteristic feature of a penalty is the lack of proportional relation between the forfeiture compelled and the damages or harm that might actually flow from the failure to perform under a contract. Whether a contractual provision is an unenforceable penalty is a question of law subject to judicial determination. When parties are not careful, they risk having a bargained-for condition in their contract struck down as an unenforceable penalty.

The general rule for whether a contractual condition is an unenforceable penalty requires a comparison of (1) the value of the money or property forfeited or transferred to the party protected by the condition to (2) the range of harm or damages anticipated to be caused that party by the failure of the condition. If the forfeiture or transfer bears no reasonable relationship to the range of anticipated harm, the condition will be deemed an unenforceable penalty.

The reference to anticipated harm or damage means that when determining whether a provision is an unenforceable penalty, courts examine the circumstances that existed at the time of the making of the contract. On the other hand, some contractual terms that appear to penalize a party may be enforceable as valid liquidated damages provisions, or on the basis that the affected party has a choice between alternative performance of the contract, or by early payment at a discount in lieu of a larger payment at a later date. This distinction, between an unenforceable penalty and one of these other methods for building in a valid and enforceable contractual remedy, is the subject of this article.

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