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Valid Liquidated Damages Or Unenforceable Penalties? A Discussion Of Recent California Appellate Court Decisions

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Contracting parties build liquidated damages provisions into their agreements in a variety of contexts. These provisions unquestionably can serve useful and legitimate functions including controlling risk exposure and ensuring that the parties will have sufficient incentive to perform. However, California courts have long recognized that a provision for liquidated damages for contractual breach can, under some circumstances, operate as an impermissible contractual forfeiture or penalty. Sections 1670 and 1671 of the 1872 Civil Code originally provided that a liquidated damages provision was enforceable only if determining actual damages was impracticable or extremely difficult. In 1977 these provisions were amended to apply the strict standard set forth in the 1872 Civil Code provisions only to certain contracts (consumer goods and leases of residential real property). For the balance of contracts, the 1977 revision liberalized the rule. The amended section 1671 subd. (b) provides: “[A] provision in a contract liquidating the damages for 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.”

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