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**THE HIGH COST OF BORROWING—LATE FEES,
ALTERNATIVE PERFORMANCE, AND GARRETT
v. COAST AND SOUTHERN FEDERAL
SAVINGS AND LOAN ASSOCIATION**

INTRODUCTION

In February, 1971, one California savings and loan association held approximately thirty-two thousand loan contracts secured by real property interests of obligors. Each contract contained a provision similar to the following:

The undersigned further agrees that in the event that payments of either principal or interest on this note becomes in default, the holder may, without notice, charge additional interest at the rate of two (2%) per cent per annum on the unpaid principle balance of this note from the date unpaid interest started to accrue until the close of the business day upon which payment curing the default is received.¹

As a result of this clause the lender had, during the preceding four-year period, collected late-payment charges totaling \$1,900,000 from some 5,000 of its 32,000 obligors.

Until the landmark decision by the California Supreme Court in *Garrett v. Coast and Southern Federal Savings and Loan Association*,² such late payment provisions were judicially permissible in California despite the courts' otherwise harsh attitude toward contractual liquidated damages, contractual penalties, and unlawful interest rates. This anomalous situation evolved from the application of the contracts concept of alternative performance and originated in California with two nineteenth-century cases³ and their progeny. In applying this concept of alternative performance to a loan situation, the courts permitted loan agreements to require an additional interest charge based on the entire principal whenever the obligor made a late payment. The courts theorized that this scheme provided an "alternative option" to making payments when due. The borrower may exercise his "option" merely by paying a substantially greater amount sometime after the original installment was due. By considering these payments within the framework of alternative performance, they

1. *Garrett v. Coast & S. Fed. Sav. & Loan Ass'n*, 9 Cal. 3d 731, 735, 511 P.2d 1197, 1199, 108 Cal. Rptr. 845, 847 (1973).

2. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

3. *Finger v. McCaughey*, 114 Cal. 64, 45 P. 1004 (1896); *Thompson v. Gomer*, 104 Cal. 168, 37 P. 900 (1894).

were subject neither to statutory requirements for liquidated damages nor to the proscription of contractual penalties.

An examination of this peculiar application of the alternative performance doctrine in the late-payment charge context will provide a background for discussion of the *Garrett* decision. Prior to this examination, however, a brief review of contractual liquidated damages provisions, with special emphasis on the California approach, is necessary in order to understand the cases which preceded *Garrett*, as well as the decisions and statutory revisions likely to follow in its wake. A proposal currently before the California Legislature that would drastically revise statutory control over liquidated damages and late charges in loan contracts will then be investigated.

LIQUIDATED DAMAGES IN CONTRACTS

Within broadly defined limits parties are normally able to establish contractual relationships. This power given by the state to parties to make their own rules and determine the allocation of risk between themselves is commonly referred to as the "freedom of contract".⁴ During the bargaining process the parties establish their mutual primary rights and obligations (that is, performance expected and owed). Additionally, the parties sometimes make provisions for remedial rights in the event that one of the parties fails to meet its primary obligations. Remedial rights include provisions for specific performance, payment of a penalty, and payment of liquidated damages. The courts, however, appear to take a considerably narrower view on the ability of contracting parties to establish remedial rights. For example, courts will often give no effect to contractual clauses providing for specific performance⁵ or a penalty⁶ in the event of breach.

Contracting parties may, however, determine in advance what amount of damages will be assessed should a breach occur. Distinguishing valid predetermined or liquidated damages from invalid contractual penalties is frequently a difficult task for the

4. Professor Justin Sweet prefers the term "party autonomy" to "freedom of contract" since he considers the latter term only an expression of the power parties possess to make contracts. Sweet, *Liquidated Damages in California*, 60 CALIF. L. REV. 84 n.1 (1972) [hereinafter cited as Sweet].

5. For a collection of cases involving judicial assessment of contractual clauses mandating specific performance in the event of breach, see MacNeil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 521-22 (1962).

6. *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal. 2d 179, 253 P.2d 10 (1953). One traditional use of the term "penalty" in the contract setting is to designate a charge that cannot qualify as a proper liquidated damage. *Garrett v. Coast & S. Fed. Sav. & Loan Ass'n*, 9 Cal. 3d 731, 736 n.4, 511 P.2d 1197, 1200 n.4, 108 Cal. Rptr. 845, 848 n.4 (1973).

courts. In deciding whether or not to permit parties to liquidate contractual damages by agreement, the court may ask whether the injury likely to result from the breach was difficult or impossible to accurately estimate,⁷ whether the parties intended to provide for damages rather than merely to penalize for failure to perform,⁸ and, finally, whether the sum stipulated by the parties was a reasonable pre-estimate of the probable loss.⁹ The last condition is often most crucial to judicial evaluation of the validity of a liquidated damages provision.¹⁰

Valid liquidated damages provisions serve several useful purposes. Corbin views such provisions as resulting in fewer breaches and fewer lawsuits, with concomitant effect of fewer and easier trials.¹¹ These provisions also aid the courts in achieving just results, since judicial determination of damages often is no better than a guess.¹² Inclusion of liquidated damages provisions permits the parties to the contract to control liability for their own breaches, which is particularly attractive in high-risk situations as an alternative to relying on the judicial process.¹³ Both the breaching and nonbreaching parties may benefit from a properly designed liquidation provision. It may be possible to include consideration for legitimate excuses for nonperformance and unusual damage-measurement problems in the calculation of the liquidated sum by the parties.¹⁴

Liquidated Damages in California

Statutory controls over liquidated damages in California are found in the California Civil Code, sections 1670-1671. Section 1670 provides that liquidation provisions are void unless they meet the requirements set forth in section 1671.¹⁵ Section 1671 states:

The parties to 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

7. *Jaquith v. Hudson*, 5 Mich. 123 (1858). See also notes 17-30 and accompanying text *infra*.

8. What the parties intended to achieve with the questioned liquidation clause may not be significant to the courts. See *United States v. Bethlehem Steel Co.*, 205 U.S. 105 (1907); *CALAMARI & PERILLO, CONTRACTS* 367 (1970).

9. *La Sala v. American Sav. & Loan Ass'n*, 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

10. *MCCORMICK, DAMAGES* §§ 148-49 (1935).

11. 5 *CORBIN ON CONTRACTS* § 1057 (1964).

12. Sweet, *supra* note 4, at 88.

13. CAL. LAW REVISION COMM'N, RECOMMENDATION RELATING TO LIQUIDATED DAMAGES 2-3 (November, 1973).

14. *Id.*

15. CAL. CIV. CODE § 1670 (West 1970).

the case, it would be impracticable or extremely difficult to fix the actual damage.¹⁶

One of the leading cases in California which interpreted the test of section 1671 is *Better Foods Markets, Inc. v. American District Telegraph Co.*¹⁷ In *Better Foods*, American District Telegraph, a supplier of burglar alarm systems, entered into an alarm service contract with the market. The contract contained a \$50 liquidation clause, which was to be invoked in the event that a failure of American's system resulted in a loss to the market. When American neglected to notify the police promptly that a robbery was in progress at the market, the felons escaped successfully with \$36,000. The California Supreme Court rejected the market's argument that determination of the "question of the impracticability and difficulty in fixing the damages" should be made "after the loss has occurred."¹⁸ The court held that the proper time for determining impracticability or difficulty in fixing damages was when the contract was made.¹⁹ The statutory requirement of impracticability or extreme difficulty in fixing damages has been termed the "difficulty of ascertainment" test for liquidated damages.²⁰ As was suggested in *Better Foods*, the California courts have adopted what has come to be called a "look forward" approach in determining when actual damages must be difficult to ascertain.²¹ The approach is predicated on the court's ability to put itself in the position of the parties when the contract was made and determine in that context whether the potential harm from breach would be impracticable or extremely difficult to ascertain.²²

The statutory language of the "difficulty of ascertainment" test does not indicate how much uncertainty is necessary in order to validate liquidated damages provisions in a contract. Supreme court cases tend to concentrate on the reasonableness of the process by which the parties estimate the compensation to be paid in the event of breach.²³ Professor Sweet found, however, that there is usually little evidence available of the process by which the parties determined stipulated amounts in most cases.²⁴

16. *Id.* § 1671.

17. 40 Cal. 2d 179, 253 P.2d 10 (1953).

18. *Id.* at 185, 253 P.2d at 14.

19. *Id.*

20. Sweet, *supra* note 4, at 131.

21. *Id.* at 131-33.

22. *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal. 2d 179, 185, 253 P.2d 10, 14 (1953); see also *McCarthy v. Tally*, 46 Cal. 2d 577, 297 P.2d 981 (1956).

23. *McCarthy v. Tally*, 46 Cal. 2d 577, 586, 297 P.2d 981, 987 (1956); *Better Foods Mkts., Inc. v. American Dist. Tel. Co.*, 40 Cal. 2d 179, 187, 253 P.2d 10, 15 (1953).

24. Sweet, *supra* note 4, at 137.

Perhaps, the process used by the parties to select liquidation amounts is not vital to the California courts as long as the amount selected is reasonable.²⁵

The California courts have refused to enforce liquidated damages provisions on equitable grounds such as coercion or oppression,²⁶ unjust enrichment,²⁷ and the decision that such a clause was a penalty assessment rather than compensation.²⁸ Of course, it is impossible to obtain completely equitable results in every decision; thus, equitable arguments usually have not moved the courts unless one of the parties would be seriously injured by enforcement of the liquidated damages provision.²⁹

Another factor that the California courts may consider in making their decision whether to permit enforcement of a liquidation provision is the amount of actual damage suffered by the beneficiary of the provision. The amount of actual damage may, for example, aid the court in determining whether the parties made a reasonable endeavor to estimate damages when they formed the contract including a liquidation provision.³⁰ But it is not required that the plaintiff affirmatively allege or prove actual damage in order to obtain judicial enforcement of the liquidation provision.³¹ If, however, the defendant can show that the plaintiff suffered no actual damage as a result of defendant's breach, the court may refuse to permit enforcement of the provision.³²

Until quite recently the California courts have paid little attention to the difference between a negotiated contract and a contract of adhesion when determining the enforceability of liquidation provisions. The apparent judicial insensitivity to this important distinction may be due to the lack of cases involving liquidation provisions in the adhesion context and lack of judicial

25. *Id.* at 138.

26. *Mente & Co., Inc. v. Fresno Compress & Whse. Co.*, 113 Cal. App. 325, 298 P. 126 (1931).

27. *Muldoon v. Lynch*, 66 Cal. 536, 6 P. 417 (1885).

28. *Id.* at 539-40, 6 P. at 418-19. According to Professor Sweet, in the context of liquidated damages, "[a] penalty is a clause designed to coerce performance rather than to estimate damages." Sweet, *supra* note 4, at 92.

29. *See, e.g., Mentel & Co., Inc. v. Fresno Compress & Whse. Co.*, 113 Cal. App. 325, 333, 298 P. 126, 129 (1921), in which the court refused to enforce contractual liquidated damages which amounted to full performance by the other party in addition to what the "injured party" had already received under the contract.

30. *See Wilmington Transp. Co. v. O'Neill*, 98 Cal. 1, 32 P. 705 (1893).

31. *McCarthy v. Tally*, 46 Cal. 2d 577, 297 P.2d 981 (1956).

32. *Eva v. McMahon*, 77 Cal. 467, 472, 19 P. 872, 874 (1888). According to Professor Sweet, "when directly faced with the question, most American courts will not knowingly enforce a liquidated damages clause where there is no actual damage." Sweet, *supra* note 4, at 139 (emphasis by the author).

awareness of the significance of this distinction in regard to liquidated damages.³³ There was, however, another reason for the apparent lack of judicial interest in the effect of liquidation provisions in the adhesion context. This reason was judicial acceptance of the use of the contracts' concept of alternative performance to insulate liquidation provisions from the strictures of California statutory controls over contractual liquidated damages.³⁴

THE DOCTRINE OF ALTERNATIVE PERFORMANCE

If a builder agrees to construct a house for someone within a given period of time or pay the other party \$4,000, one approach to the payment provision is to classify it as liquidated damages in the event that the builder fails to perform within the time limitation. The court may, however, consider the payment provisions as an alternative performance in consideration of the "privilege" of finishing late. By this method of interpretation, the agreement becomes an option contract in which the price for the option to terminate is fixed.³⁵ The latter approach provides an obvious advantage to the "innocent" party in a jurisdiction where liquidated damages provisions are carefully scrutinized by the courts, particularly if the payment provision could not survive as a liquidated damage.³⁶ The California courts adopted this alternative performance approach in evaluating late-charge provisions in loan contracts.³⁷ Frequently those provisions were unacceptable when viewed as liquidated damages.³⁸ Nevertheless, this alternative performance approach was accepted in California until 1973, when *Garrett v. Coast and Southern Federal Savings and Loan Association*³⁹ was decided. This novel treatment of late-charge provisions, which seems to have been unique to California, was derived from four cases,⁴⁰ two of which were decided before the turn of the century.⁴¹

33. Sweet, *supra* note 4, at 139.

34. CAL. CIV. CODE §§ 1670-71 (West 1970); see text accompanying notes 15-22 *supra*.

35. CALAMARI & PERILLO, CONTRACTS 369-70 (1970).

36. For example, the defendant could demonstrate that the plaintiff had suffered no loss as a result of the breach or that the process for determining the cost of the "option" was unreasonable. See text accompanying notes 23-32 *supra*.

37. See text accompanying notes 46-80 *infra*.

38. See text accompanying notes 98-102 *infra*.

39. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

40. *Finger v. McCaughey*, 114 Cal. 64, 45 P. 1004 (1896); *Thompson v. Gorner*, 104 Cal. 168, 37 P. 900 (1894); *Walsh v. Glendale Fed. Sav. & Loan Ass'n*, 1 Cal. App. 3d 578, 81 Cal. Rptr. 804 (1969); *O'Connor v. Richmond Sav. & Loan Ass'n*, 262 Cal. App. 2d 523, 68 Cal. Rptr. 882 (1968).

41. *Finger v. McCaughey*, 114 Cal. 64, 45 P. 1004 (1896); *Thompson v. Gorner*, 104 Cal. 168, 37 P. 900 (1894).

Thompson v. Gorner:⁴² introduction of alternative performance doctrine

In *Thompson* the borrower gave the lender a mortgage interest in real property to secure a promissory note which included the following interest provision:

With interest thereon . . . at the rate of eight per cent per annum . . . and if said principal or interest is not paid as it becomes due it shall thereafter bear interest at the rate of one percent per month.⁴³

After the note matured, the borrower continued to pay the lender interest at the eight percent rate for two additional years without paying back the principal of the loan. At the end of this period, the lender notified the borrower that no further interest installments would be accepted unless such installments included the additional one percent interest.⁴⁴ The California Supreme Court, holding for the lender, concluded that the payment of an additional one percent interest, as specified in the note, was not a contractual penalty for nonperformance, but was instead a special contract to pay a *different* interest rate *upon a contingency*: failure to tender full payment of principal and interest when the note matured.⁴⁵

The reasoning behind the supreme court's decision in *Thompson* was questionable. Although the trial court had found the extra interest charge assessed after maturity of the note was a penalty, the supreme court was satisfied with its reversal on first hearing based on the doctrine of alternative performance.⁴⁶ The decision on first hearing combined the broad definition of "interest" in section 1915 of the Civil Code⁴⁷ with the unlimited freedom allowed contracting parties in selecting interest rates under section 1918 of the Code⁴⁸ to reach the conclusion that "parties may agree in writing for such rate of interest as

42. 104 Cal. 168, 37 P. 900 (1894).

43. *Id.* at 169, 37 P. at 901.

44. *Id.*

45. *Id.* at 170, 37 P. at 901. The court, however, viewed the lender's prior acceptance of payments at the lower rate of interest as a waiver of the late provision during that period, thus making the borrower liable for the higher rate only after the lender demanded it. This was the second hearing by the supreme court on *Thompson*. The first hearing, which was unreported, provided the bulk of the reasoning upon which the *Thompson* court relied and is discussed below.

46. *Id.*

47. CAL. CIV. CODE § 1915 (West 1970), which provides:

Interest is the compensation allowed by law or fixed by the parties for the use, or forbearance, or detention of money.

48. Former section 1918 of the Civil Code, which was repealed by an initiative measure in 1918, provided that parties could agree in writing for the payment of any rate of interest which would be allowed, according to the terms of the agreement, until the entry of judgment. Cal. Stats. (1919), lxxxvii, § 4.

they choose, not only before the maturity of the contract, but after its breach, and until paid."⁴⁹ The payment of additional interest in this case was "to be enforced as per contract, and not treated as penalties."⁵⁰ The conditions which activated this contractual alternative were maturity and nonpayment of the note.⁵¹ In effect then, the argument was that no actual breach had occurred. In addition to declaring that the supplemental interest charge of one percent per month after maturity was not a penalty, the holding on first hearing had, by implication, indicated that the Civil Code provisions controlling liquidated damages⁵² were not applicable, since no breach had occurred.

The *Thompson* approach to supplementary interest provisions was significantly extended by the California Supreme Court two years later in *Finger v. McCaughey*.⁵³

Finger v. McCaughey.⁵⁴ *retroactive late-payment interest*

Finger, like *Thompson*, involved a note secured by a mortgage. When the note matured, the borrower failed to tender full payment. The interest provision in the *Finger* note, however, differed significantly from the provision in the *Thompson* note:

With interest from date at the rate of ten per cent per annum, provided this note is paid at maturity, but if not paid at maturity, then it shall bear interest at the rate of twelve per cent per annum *from its date* until paid, and, if the interest is not paid at the end of one year from date, it shall become a part of the principal and bear twelve per cent interest per annum.⁵⁵

The court, again holding for the lender, found the agreement between the parties for an increased interest rate contingent on nonpayment of either principal or interest when due permissible as an alternative performance.⁵⁶ In addition, the court permitted *retroactive* application of the increased interest rate to the date when the loan was made.⁵⁷

49. *Thompson v. Gerner*, 36 P. 434, 435, 4 Cal. Unrep. 606, 608 (1894).

50. *Id.* at 435, 4 Cal. Unrep. at 609.

51. *Id.*

52. CAL. CIV. CODE §§ 1670-71 (West 1970).

53. 114 Cal. 64, 45 P. 1004 (1896).

54. *Id.*

55. *Id.* at 65, 45 P. 1004 (emphasis added).

56. *Id.* at 66, 45 P. at 1004. The *Finger* court cited *Thompson* as the sole support for its decision.

57. The *Finger* court also held that interest accruing *after* maturity of the note could not be compounded because of strict statutory requirements as to specificity in any loan agreement looking to *compound* interest. *Id.* The *Finger* court cited as support section 1919 of the Civil Code (which was abolished by the same initiative measure that abolished section 1918, Cal. Stats. (1919),

The *Finger* court dismissed arguments on behalf of the borrower's estate that the attempt to increase the interest on breach and to have such increase relate back to the date of the note was really a penalty and therefore void; the court saw no substantial ground for distinguishing *Finger* from *Thompson*.⁵⁸ The court apparently ignored the basic difference in the computation of the resulting interest charges under *Thompson* and *Finger*, the date upon which the higher interest rate began.

Following the *Finger* reasoning, a note which contains a basic interest rate favorable to the borrower, along with an "alternative interest provision" similar to the one accepted by the borrower in *Finger*, could become an extremely unfavorable contract for the borrower after maturity. The determining factors for computing the extra interest charge became the alternative interest rate and the total time that credit had been extended.⁵⁹ Although the *Finger* court deemed the special interest provision an alternative performance, the provision produced the same result as a liquidated damages clause. The borrower, however, was denied the relief he might have gained under sections 1670 and 1671 of the Civil Code.⁶⁰ Instead, he was required to "perform" in the alternative by paying interest charges based on an augmented interest rate.

At the time *Thompson* and *Finger* were decided, however, this result may not have been as onerous as it seems by current standards. It is likely that the contracts in those cases were the products of *mutual* bargaining in which neither the lender nor the borrower held the upper hand (that is, bargaining "at arm's length"). In any event, neither *Thompson* nor *Finger* appeared to involve a situation in which the lender dictated interest terms to the borrower. The same may not be said for modern consumer lending practices, which are best characterized by standard form contracts, in which borrowers have a significantly limited opportunity to bargain for terms.⁶¹

Yet despite this fundamental difference in the bargaining process, subsequent courts adopted the *Thompson* and *Finger* holdings.

lxxxvi, § 4), which provided that delinquency charges authorized by the contract and accruing during the term of the contract could, if the contract so provided, become part of the principal and thereafter bear the same rate of interest as the principal.

58. 114 Cal. at 66, 45 P. at 1004.

59. Thus, it would seem that a lengthy period *before* maturity of the note would result in a large late-interest charge.

60. See text accompanying notes 26-30 *supra*.

61. Sweet, *supra* note 4, at 85.

O'Connor v. Richmond Savings and Loan Association.⁶²
alternative performance doctrine and installment payments

During the seventy-two years between the *Finger* and *O'Connor* decisions the California courts said little about the status of late-payment provisions in loan contracts.⁶³ In 1934, however, a new amendment regulating interest rates was added to the California Constitution.⁶⁴ This measure placed a ten percent per annum maximum on the rate of interest for a loan, but the measure specifically excepted savings and loan associations from the scope of its coverage.⁶⁵

In *O'Connor*, a group of successor trustors on trust deeds given by a home builder to a savings and loan association complained to the court about the harsh effects of the late-payment provision in the loan agreement, which provided that:

"in the event any installment shall not be paid when due," the obligor thereunder shall pay "an *additional interest charge upon the balance of said principal sum* then unpaid at the rate of one-half of 1 percent per month from the date such installment was due until the same shall be paid."⁶⁶

As a result of the builder's failure to meet his loan commitments to the lender before conveyance to his successors in interest, each of the new owners found himself faced with substantial late charges owing to the lender.⁶⁷ The appellate court held that the liquidated damages provisions of the Civil Code were inapplicable since *Thompson* and *Finger* were the controlling precedents in the case.⁶⁸ Although the victims of the late charges argued that *Thompson* and *Finger* were wrongly decided by the California Supreme Court, they were forced to admit that neither case had ever been disapproved or overruled.⁶⁹

A crucial result of the *O'Connor* decision, judicial extension

62. 262 Cal. App. 2d 523, 68 Cal. Rptr. 882 (1968).

63. *Yndart v. Den*, 116 Cal. 533, 48 P. 618 (1897), simply reiterated the arguments of *Thompson* and *Finger*.

64. CAL. CONST. art. XX, § 22, which provides in part:

The rate of interest upon the loan or forbearance of any money, goods or things in action, or on accounts after demand or judgment rendered in any court of the State, shall be 7 percent per annum but it shall be competent for the parties to any loan or forbearance of any money, goods or things in action to contract in writing for a rate of interest not exceeding 10 percent per annum. . . . However, none of the above restrictions shall apply to any building and loan association as defined in and which is operated under that certain act known as the "Building and Loan Association Act"

65. See, e.g., *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n*, 22 Cal. App. 3d 303, 308, 99 Cal. Rptr. 417, 420 (1971).

66. 262 Cal. App. 2d at 529, 68 Cal. Rptr. at 886 (emphasis added).

67. *Id.* at 525, 68 Cal. Rptr. at 883.

68. *Id.* at 530, 68 Cal. Rptr. at 886.

69. *Id.* at 531, 68 Cal. Rptr. at 887.

of the doctrine of alternative performance to an *installment* payment situation, was announced without comment by the court. Neither *Thompson* nor *Finger* had involved provisions for installment payments on loans. Likewise, the *O'Connor* court failed to note that while only one borrower was held liable in *Thompson* and in *Finger*, seventeen borrowers ultimately bore the brunt of the late charges assessed by Richmond Savings and Loan Association.⁷⁰ The court ignored the passage of time since *Thompson* and *Finger* had been decided, and reasoned that the adoption of the usury laws in 1934 had not marred the applicability of the *Thompson* and *Finger* holdings; the court felt bound to follow these decisions.⁷¹

*Walsh v. Glendale Federal Savings and Loan Association:*⁷²
the final step

In *Walsh*, decided one year after *O'Connor*, the borrower had obtained several loans from a savings and loan association secured by one deed of trust. Each promissory note contained the following provision:

Undersigned agrees, in the event any installment shall not be paid when due, to pay the holder at its option and without notice, an additional interest charge upon the balance of said principal sum then unpaid at the rate of one-half of one percent per month from the date such installment was due until the same shall be paid.⁷³

The borrower repeatedly fell behind in making payments and suffered frequent assessments on the amount owed. Finally, after the borrower obtained refinancing from another source, he brought an action against the lender which included a challenge of the late-charge provisions.⁷⁴

In response to the borrower's assertion that the late-charge provisions were contractual penalties for nonperformance and therefore void, the court held that "[i]t is the rule in this state that late-charge interest is not in the nature of a penalty, and is valid."⁷⁵ Drawing on *O'Connor*, which the *Walsh* court considered to contain a *complete* discussion of the applicable law on this subject, the court refused to uphold the borrower's contention that the late-charge provision must be evaluated according to the

70. The *O'Connor* decision involved seventeen trust deeds which contained identical late-charge provisions. *Id.* at 524-25, 68 Cal. Rptr. at 883.

71. *Id.* at 530 n.1, 68 Cal. Rptr. at 887 n.1.

72. 1 Cal. App. 3d 578, 81 Cal. Rptr. 804 (1969).

73. *Id.* at 581, 81 Cal. Rptr. at 806.

74. *Id.* at 581-82, 81 Cal. Rptr. 806-07.

75. *Id.* at 585, 81 Cal. Rptr. at 809.

strictures of the liquidated damages sections of the Civil Code.⁷⁶ The *Walsh* court, like the *O'Connor* court, relied on the doctrine of alternative performance to distinguish late charges from liquidated damages.⁷⁷

It is difficult to ascertain what policy was being advanced by the *O'Connor* and *Walsh* courts. Despite their averments of *stare decisis*, they could not realistically overlook drastic changes in the contractual bargaining process during the seventy years separating the *Finger* and *O'Connor* decisions, the disparate bargaining position of the parties, and the substantially *new* effect of extending the alternative performance rationale to individual installment payments controlled by late-payment provisions. Both *Thompson* and *Finger* involved loan contracts between *individuals*, while *O'Connor* and *Walsh* involved individual borrowers and institutional lenders. Presumably, in *Thompson* and *Finger* there was a possibility that the parties reached the terms of their agreements through mutual bargaining.⁷⁸ In *O'Connor* and *Walsh* the borrowers probably had no input into the terms of their contracts beyond the determination of the basic interest rate and the payment date.⁷⁹ Finally, the lenders in *Thompson* and *Finger* did not assess late-interest charges until the entire debt had matured. The decisions in *O'Connor* and *Walsh* permitted the lender to assess a late-interest charge each time the borrower missed a payment. The *O'Connor* and *Walsh* late-interest provisions did not stop at this point, however. The lenders in the latter two cases were allowed to reach principal that had *not yet matured* with late-interest charges.⁸⁰

The California courts thus left borrowers at the mercy of large lending institutions that were exempt even from usury laws. Judicial "sympathy" for the "plight" of these lenders in seeking to "persuade" borrowers to pay promptly does not explain why the courts placed a cudgel in their hands to enforce payment. It may be argued that the only reasonable, though unannounced, policy behind the *O'Connor* and *Walsh* decisions was recogni-

76. *Id.*

77. *Id.* at 586-87, 81 Cal. Rptr. at 809-10.

78. There are no specific factual indications in *Thompson* or *Finger* as to the manner in which the terms of the respective notes were determined by the parties. Considering, however, the nature of the promissory notes (i.e., short-term loans which produced relatively insignificant late charges), it is more likely that both parties in the respective transactions contributed to the terms of the agreements, than that the lending parties dictated terms to the borrowers.

79. See note 61 and accompanying text *supra*. It may be questioned whether the borrowers even had the opportunity to participate in determination of the interest rate on the loan, in that interest rates do not usually differ significantly among savings and loan associations.

80. See text accompanying notes 66-77 *supra*.

tion of the widespread use of similar late-charge provisions in the savings and loan industry and determination not to "rock the boat" until the legislature acted.

Yet in 1973, when the California Supreme Court heard arguments by the parties in *Garrett v. Coast and Southern Federal Savings and Loan Association*,⁸¹ the legislature had not acted on late fees despite tacit admissions by lenders in official legislative reports that a primary purpose of these charges was "motivation" of the borrower to make prompt payment of the installment, reducing the need for institution of foreclosure proceedings.⁸² For the present the legislature had abdicated initiative to the courts, which took up the challenge.

THE DEPARTURE FROM THE DOCTRINE OF ALTERNATIVE PERFORMANCE

*Garrett v. Coast and Southern Federal Savings and Loan Association*⁸³

Roberta L. Garrett was one of numerous borrowers whose loan contracts contained a two percent per annum late interest charge provision.⁸⁴ Garrett brought suit on behalf of herself and a class of similarly situated obligors⁸⁵ who fell within the applicable period of limitations,⁸⁶ seeking to recover sums paid in satisfaction of the late charges. The plaintiffs contended that the assessments were improper since the late-charge provisions could not

81. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

82. See notes 111-12 and accompanying text *infra*.

83. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

84. See notes 1-2 and accompanying text *supra*.

85. CAL. CIV. PRO. CODE § 382 (West Supp. 1974) provides in part that when the question is one of a common or general interest, of many persons, or when the parties are numerous, and it is impracticable to bring them all before the court, one or more may sue or defend for the benefit of all.

It is noteworthy that this was the first challenge by class action of the status of late-charge provisions based on interest on the entire principal. It seems important in that it may serve as a further indication of how wide-spread the practice of including similar provisions in contracts had become in the loan industry. See also 9 Cal. 3d at 740 n.8, 511 P.2d at 1203 n.8, 108 Cal. Rptr. at 851 n.8, in which the *Garrett* court includes the results of a study conducted by the State Savings and Loan Commissioner in 1966. The report establishes that a large number of state-licensed savings and loan associations charged late fees calculated on the entire principal of the loan.

86. Presumably, the class action in *Garrett* would fall under CAL. CIV. PRO. CODE § 337 (West 1970), which provides in part:

Within four years . . . 3. An action based upon the rescission of a contract in writing. The time begins to run from the date upon which the facts that entitle the aggrieved party to rescind occurred. Where the ground for rescission is fraud or mistake, the time does not begin to run until discovery by the aggrieved party of the facts constituting the fraud or mistake. . . .

qualify as valid liquidated damages under the Civil Code.⁸⁷ Plaintiffs alleged that the defendant association caused all of its contractual installments to be due and payable on the same day of each month, and automatically sent late notices to all obligors who failed to submit full payment within nine days of that due date. Those who failed to meet this deadline were assessed late charges by the association. In calculating the charges for delinquent payments, the lender made no attempt to distinguish between those who paid their installments a few days late, a few weeks late, or not at all for the month in question.⁸⁸ The association demurred to the plaintiffs' contention that the late charges were assessments which could not qualify as liquidated damages and were therefore void.⁸⁹ The trial court entered a dismissal after sustaining, without leave to amend, the defendant's demurrer on the ground that the complaint failed to state a cause of action.⁹⁰ The dismissal order was affirmed by the court of appeal.

In a unanimous opinion written by Chief Justice Wright, the California Supreme Court reversed the order of dismissal and remanded the cause to the trial court with directions to overrule the association's demurrer.⁹¹ Although limited on this appeal to a determination of the sufficiency of the complaint as a matter of law, the supreme court chose to thoroughly examine the legality of late-charge interest provisions in loan agreements. The court specifically evaluated the doctrine of alternative performance in this context, analyzed the meaning and ramifications of *Thompson, Finger, O'Connor, and Walsh*, and, finally, tested late-charge interest provisions against the statutory provisions for liquidated damages.⁹² In short, the *Garrett* court was seeking the true function and character of late-charge interest provisions.⁹³

The supreme court rejected interpretation of the late-charge interest provisions as alternative performance under the contracts. The court reasoned that the consideration given by the borrower for the contractual "option" to pay late was, in reality, a penalty for nonperformance.⁹⁴ The *Garrett* court determined that accept-

87. 9 Cal. 3d at 734, 511 P.2d at 1199, 108 Cal. Rptr. at 847. See also text accompanying notes 15-30 *supra*.

88. 9 Cal. 3d at 734, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

89. *Id.* The defendant had also demurred to the plaintiffs' complaint on the ground that the cause was not the proper subject of a class action, but the lower court had overruled the demurrer as to that ground and the defendant had not appealed the ruling. *Id.* at 735 n.2, 511 P.2d at 1199 n.2, 108 Cal. Rptr. at 847 n.2.

90. *Id.* at 734, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

91. *Id.* at 742, 511 P.2d at 1204, 108 Cal. Rptr. at 852.

92. CAL. CIV. CODE §§ 1670-71 (West 1970).

93. 9 Cal. 3d at 735, 511 P.2d at 1199, 108 Cal. Rptr. at 847.

94. *Id.* at 737, 511 P.2d at 1200-01, 108 Cal. Rptr. at 848-49.

ance of the late-charge provision as an alternative performance amounted to condonation of a result directly prohibited by the legislature.⁹⁵ Permitting forfeiture of an apparent penalty in exchange for the "right" to exercise an "option" to default on making timely installment payments, the court reasoned, is inconsistent with the legislative intent to control liquidated damages. Clearly it was the duty of the court to ignore form and seek out substance in arrangements which purport to legitimate penalties and forfeitures.⁹⁶

The *Garrett* court adopted a harsh attitude toward the progeny of *Thompson*. The court specifically overruled *Finger's* retroactive application of late-charge interest to the full principal of a loan by means of an alternative performance theory. It reasoned that since the increased interest rate was made retroactive, the borrower became obligated for a sum in addition to what he had contracted to pay under the terms of the promissory note as a direct consequence of default. Accordingly, the validity of the interest provision should have been controlled by applicable statutory provisions relating to liquidated damages.⁹⁷ Without discussing the factual situations in *O'Connor* and *Walsh*, the court added that it disapproved of these decisions for the same reason it had disapproved of *Finger*.⁹⁸ The *Garrett* court then outlined its approach to the doctrine of alternative performance by stating that

when it is manifest that a contract expressed to be performed in the alternative is in fact a contract contemplating but a single, definite performance with an additional charge contingent on the breach of that performance, the provision cannot escape examination in light of pertinent rules relative to the liquidation of damages.⁹⁹

It was apparent to the *Garrett* court that the defendant's late-charge provision failed to meet the statutory requirements for liquidated damages. The court found that the lender had imposed by contract an additional sum to be paid by the borrower in the event of default. Although this sum was indicated by the

95. *Id.* at 737, 511 P.2d at 1201-02, 108 Cal. Rptr. at 848-49.

96. *Id.* at 737, 511 P.2d at 1201, 108 Cal. Rptr. at 849. See *Caplan v. Schroeder*, 56 Cal. 2d 515, 64 P.2d 371, 15 Cal. Rptr. 145 (1961); *Freedman v. The Rector*, 37 Cal. 2d 16, 230 P.2d 629 (1951).

97. 9 Cal. 3d at 737, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

98. *Id.* at 737-38, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

99. *Id.* at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849. See also *Paolilli v. Piscitelli*, 45 R.I. 354, 121 A. 531 (1923); WILLISTON, *CONTRACTS* § 781 (3d ed. 1957). The *Garrett* court indicated that "[p]erformance cannot be said to be in the alternative where breach of a former covenant is necessary to give effect to a later covenant." 9 Cal. 3d at 738 n.6, 511 P.2d at 1201 n.6, 108 Cal. Rptr. at 849 n.6.

contract to be an interest charge, the court construed it as a penalty in the absence of a showing that the sum bore any relationship to a loss suffered by the lender as a result of the borrower's default.¹⁰⁰ The court noted that there is a fundamental difference between interest and penalty charges; interest is a measure of compensation to which an obligee is entitled, while a penalty is punitive in nature. Likewise, a charge for late payment of a loan installment that is measured against the unpaid balance of the loan was held by the court to be punitive in that it is nothing more than an attempt to coerce timely payment by a forfeiture that is not reasonably calculated to compensate the injured lender.¹⁰¹

If the sum extracted from the borrower is designed to exceed substantially the damages suffered by the lender, the provision for the additional sum, whatever its label, is an invalid attempt to impose a penalty inasmuch as its primary purpose is to compel prompt payment through the threat of imposition of charges bearing little or no relationship to the amount of the actual loss incurred by the lender.¹⁰²

The *Garrett* court did not advocate allowing defaulting borrowers to escape unscathed. It noted that in the present action Coast was still entitled to actual damages it had suffered as a result of the defaults. Actual damages could include an amount based on the size of the payments and the period they had been wrongfully withheld. Additionally, the lender was to be allowed to charge the borrower for administrative costs reasonably related to the collection and accounting for the late payment.¹⁰³

Although the *Garrett* court did not deny the possibility of providing liquidated damages provisions in loan contracts that could withstand the scrutiny of sections 1670-1671 of the Civil Code, it offered little encouragement for this approach. The court noted that damages for the wrongful withholding of money

100. 9 Cal. 3d at 739, 511 P.2d at 1202, 108 Cal. Rptr. at 850. The *Garrett* court supported this finding with a statement from the defendant's loan booklet, which was issued to each borrower:

Payments should be mailed early enough to reach us by the due date. The cost of handling delinquent payments, even when we know in advance that they will be late, amounts to more expense than most people imagine. Hence we spread the entire average expense among the customers who are late; these charges are quite high. . . .

Id. at 739 n.7, 511 P.2d at 1202 n.7, 108 Cal. Rptr. at 850 n.7.

101. *Id.* at 739-40, 511 P.2d at 1202-03, 108 Cal. Rptr. 850-51.

102. *Id.* at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851. See also *First Am. Title Ins. & Trust Co. v. Cook*, 12 Cal. App. 3d 592, 596-97, 90 Cal. Rptr. 645, 647 (1970); *Lagorio v. Yerxa*, 96 Cal. App. 111, 214 P.2d 828 (1929); cf. *Clermont v. Secured Inv. Corp.*, 25 Cal. App. 3d 766, 769, 102 Cal. Rptr. 340, 342 (1972).

103. 9 Cal. 3d at 741, 511 P.2d at 1203, 108 Cal. Rptr. at 851. See *Farthing v. San Mateo Clinic*, 143 Cal. App. 2d 385, 299 P.2d 977 (1956).

are fixed by law in California¹⁰⁴ and that other damages that the lender might suffer as a result of the borrower's default, such as administrative and accounting costs, do not appear to present extreme difficulty in determining prospectively.¹⁰⁵

It may be posited that the *Garrett* decision reflects "the age of consumerism." Through a logical series of steps the supreme court pierced the facade of alternative performance and exposed the late interest charge for what it was, an invalid penalty for nonperformance. The *Garrett* court, unlike the *O'Connor* and *Walsh* courts, was willing to acknowledge inferentially that "arm's length bargaining" is a myth for the consumer. The reality for the consumer is the form contract. He assents through reading and signing, rather than through bargaining for the terms of the contract. Thus, to accord special sanctity to this type of contractual language ignores the actual relationship between the parties.¹⁰⁶

The practical effect of the *Garrett* decision on late-payment charges based on similar contractual provisions that have already been assessed by other lenders, and that fall within the applicable statute of limitations will, barring legislative intervention,¹⁰⁷ have to be decided by the courts. If, as it has been suggested above, the use of such delinquency provisions is widespread, millions of dollars are at stake.¹⁰⁸

THE FUTURE OF LIQUIDATION CLAUSES IN LOAN CONTRACTS AFTER GARRETT

As a consequence of the *Garrett* decision, late-charge provisions in loan contracts must now meet the criteria for valid liquidated damages or fail as contractual penalties for nonperformance. This requirement may prove to be a hollow victory for consumers. Were the lender able to devise a late-payment provision that could survive as a liquidation clause, a task which the *Garrett* court indicated would probably fail, this provision could not contain a "motivation factor," a sum reasonably designed to

104. CAL. CIV. CODE § 3302 (West 1970) provides:

The detriment caused by the breach of an obligation to pay money only, is deemed to be the amount due by the terms of the obligation, with interest thereon.

105. 9 Cal. 3d at 741 n.11, 511 P.2d at 1204 n.11, 108 Cal. Rptr. at 852 n.11.

106. Sweet, *supra* note 4, at 85.

107. For a recent example of legislative nullification of a California Supreme Court decision that portended millions of dollars in potential liability for the savings and loan industry, see *Connor v. Great W. Sav. & Loan Ass'n*, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968), which was abrogated by CAL. CIV. CODE § 3434 (West 1970), passed the following year.

108. See note 86 *supra*.

"encourage" prompt payment of the installment, without amounting to an exorbitant or unconscionable charge.¹⁰⁹ Instead the lender would be entitled to no more than interest on the amount of the payment for the period it was wrongfully withheld, and administrative and accounting costs incurred by the lender as a result of the withholding of the payment, in addition to the principal amount of the payment.¹¹⁰ Since the sum of these extra charges would be considerably less than a charge based on an interest assessment against the principal of the loan, the "motivation factor" of the late charge would be substantially reduced, if not eliminated. When this "motivation factor" is absent, lenders argue, borrowers are tempted to use their funds to meet obligations other than the installment payment.¹¹¹ Most lenders will allow no more than sixty days to elapse from the due date of payment before filing notice of a delinquency and instituting foreclosure proceedings. Once foreclosure proceedings are under way, the cost to the borrower for curing the default is significantly higher than a reasonable late fee.¹¹²

The effectiveness of such a "motivation factor" may, however, be disputed. At the time a borrower executes a promissory note, he will usually pay little attention to late-payment provisions or other penalty provisions. The main interests of a borrower in a real property loan transaction are the interest rate, the term of the loan, and the monthly payments. Most borrowers have no intention of making late payments when they obtain the loan and are not apt to quibble over delinquency payment clauses.¹¹³ Since significant bargaining between the parties is unlikely in any event,¹¹⁴ the borrower must accept whatever late-payment charges the lender chooses and the law permits.

The above analysis suggests that legislative reform may be the only satisfactory method to strike a balance between the need for the lender to protect his investment and the plight of the borrower seeking to escape foreclosure when he makes late installment payments.

A current proposal before the California Legislature provides

109. See text accompanying notes 5 and 21 *supra*.

110. See notes 103-05 and accompanying text *supra*. Since savings and loan associations are not presently subject to usury laws (see notes 64-65 and accompanying text *supra*), it is not clear how much interest they may charge for money withheld wrongfully by borrowers.

111. CALIFORNIA ASSEMBLY FINANCE AND INSURANCE COMMITTEE, FINAL REPORT ON LATE PAYMENT FEES 11-12 (May 20, 1970).

112. *Id.*

113. *Id.* at 12-13.

114. See text accompanying note 106 *supra*.

one potential approach to striking this balance.¹¹⁵ This proposal was developed in late 1973 by the influential California Law Revision Commission and seeks a general overhaul of the California Civil Code provisions regulating liquidated damages in contracts.¹¹⁶ The proposal would replace the current code sections with a new series of provisions which would necessitate an altered judicial approach to liquidated damages in general and to late-payment charges in loan contracts in particular.

The Law Revision Commission Proposal—Liquidated Damages

With regard to liquidated damages, the legislative proposal stipulates that contractual provisions for liquidated damages, unless otherwise regulated by statute, will be valid unless found to be unreasonable.¹¹⁷ The Law Revision Commission believes that this language would reverse the basic disapproval of liquidated damages provisions reflected in the present statutory language¹¹⁸ and case law,¹¹⁹ while still allowing the courts to set aside such provisions in situations where the provisions are oppressive.¹²⁰ The Commission further recommends that when the courts do intervene to evaluate liquidated damages provisions, they should judge the "reasonableness" of a provision in view of the circumstances confronting the parties at the time the contract was made.¹²¹ The courts should not include the perspective of hindsight in making their determination as to the amount of damages, since that defeats one of the primary purposes for including a liquidation provision in a contract: avoiding litigation in determining the amount of actual damages.¹²²

The comment to the proposed liquidated damages statute limits the circumstances which may be taken into consideration

115. Cal. S.B. 1532, Reg. Sess., introduced by State Senator Stevens on January 10, 1974.

116. CAL. CIV. CODE §§ 1670-71 (West 1970).

117. The new provision for liquidated damages provided for in Cal. S.B. 1532 would become CAL. CIV. CODE § 3319, and provide:

(a) Except as otherwise provided by statute, a provision in a contract liquidating the damages for breach of a contractual obligation is valid unless the party seeking to invalidate the provision establishes that it was unreasonable under the circumstances existing at the time of the making of the contract.

(b) Subdivision (a) does not apply to provisions included in public contracts pursuant to Section 14376 or 53069.85 of the Government Code.

118. 11 CAL. LAW REVISION COMM'N, REPORTS, RECOMMENDATIONS & STUDIES 1201, 1209 (1973) [hereinafter cited as CLRC].

119. *Id.* See also text accompanying notes 24-30 *supra*.

120. CLRC, *supra* note 118, at 1209.

121. *Id.* See also text accompanying notes 19-22 *supra*.

122. CLRC, *supra* note 118, at 1209; see text accompanying note 25 *supra*.

in determining the "reasonableness" of a particular provision. The relative equality of bargaining power of the parties could be appraised. Likewise, evidence of anticipation by the parties that proof of actual damages would be costly or inconvenient to determine may be considered. The amount of damages stipulated by parties may be compared to the range of damages that could have been reasonably forecast by the parties when the contract was made. Finally, whether or not the liquidation clause results from a "form contract" provided by one of the parties may be taken into consideration in determining the "reasonableness" of the clause. If a "form contract" is involved, the court should then carefully scrutinize the circumstances at the time the contract was made to insure against "unreasonable benefits" accruing to the party who submitted the contract. The comment further stipulates that nothing in the new statute would affect the power of the court to modify or nullify a contract of adhesion.¹²³

The list of circumstances relevant to the determination of "reasonableness" of liquidated damages provisions reflects a tightening of the "look forward" approach in evaluating such provisions. In addition to replacing statutory antipathy with sympathy for liquidation provisions, the list implements a policy favoring such provisions.¹²⁴ With the exception of form contracts, the court may not look beyond the time at which the contract was made in reaching a conclusion regarding the "reasonableness" of a liquidation clause. As further evidence of a more expansive approach to liquidation provisions, the comment includes a specific reference to placement of the burden of proof in cases involving such provisions. The Law Revision Commission advocates placing the burden of pleading and proving that a liquidation provision is invalid on the party seeking to avoid the provision.¹²⁵ The comment to the proposed statutory enactment on liquidated damages concludes that the new section

does not limit the use of liquidated damages provisions to cases where damages would be difficult to fix or where the amount selected by the parties reflects a reasonable effort to estimate the probable amount of actual damages. Instead, the parties are given considerable leeway to determine damages for breach. All the circumstances existing at the time of the making of the contract are considered including but not limited to the relationship the damages provided bear to the range of harm that reasonably could be anticipated at the time of the making of the contract.¹²⁶

123. CLRC, *supra* note 118, at 1223.

124. *Id.* at 1209.

125. *Id.*

126. *Id.* at 1224 (emphasis by the authors).

It appears likely that the Commission's proposal on liquidated damages would, if enacted, encourage the use of liquidated damages provisions in contracts. It may be queried, however, whether this encouragement is beneficial. In an ideal situation involving informed parties represented by counsel and specific negotiation over liquidation provisions, the proposed statute may, as the Commission asserts, serve the interests of both parties.¹²⁷ But how frequently does this situation occur? As was suggested above, evidence pertaining to the manner in which contracting parties determine liquidation amounts usually is not readily available.¹²⁸ It does not seem to this writer that saddling the breaching party with a strong statutory presumption in favor of the liquidation provision provides a satisfactory solution.

This criticism is not intended to imply that the Commission's proposal on liquidated damages is without merit. This writer agrees with the Commission's position "that the use of liquidated damages provisions is beneficial and should be encouraged, subject to limitations to protect against the oppressive use of such provisions."¹²⁹ "Encouragement," however, is not the same as "burden of proof". *Relaxing* the burden of proof on the party seeking to benefit from the liquidated damages provision would probably have the effect of encouraging the use of such provisions without "digging a presumptive grave" for the defaulting party. This writer feels that a total shift of the burden of proof to the defaulting party would be unnecessarily harmful to his interests.

The Law Revision Commission Proposal—Late-Payment Charges on Loans Secured by Real Property

In contrast to the proposal's suggested relaxation of legislative controls over liquidated damages, narrow limitations on the use of liquidated damages in the form of late-payment charges on installment loans secured by real property are advocated in the proposed legislation.¹³⁰ Although the recommended statute

127. CLRC, *supra* note 118, at 1208-09. See also text accompanying notes 11-14 *supra*.

128. See text accompanying note 24 *supra*.

129. CLRC, *supra* note 118, at 1209; see text accompanying notes 11-14 *supra*.

130. The new provision for late payment charges indicated in Cal. S.B. 1532 would be CAL. CIV. CODE § 2954.6, which provides:

(a) As used in this section:

(1) "Late payment charge" means a charge, whether or not characterized in the loan contract as interest, that is imposed for late payment of an installment payment due on a loan secured by a mortgage or deed of trust on real property.

(2) "Installment payment" means that portion of a periodic pay-

would allow such late-payment charges, it prohibits their levy against the borrower unless he fails to pay the full amount of that installment within ten days of the scheduled due date of the installment. Payments received by the lender must be applied first to the current installment that is due; any surplus may be ap-

ment that comprises any one or more of the following: principal, interest, and funds to be allocated to impound accounts for property taxes, special assessments, and insurance.

(b) Except as provided in subdivision (c), a provision in the loan contract imposing a late payment charge is valid if it satisfies the requirements of Sections 2954.5 and 3319 [for the text of § 2954.5, see note 108 *infra*].

(c) Where each of a majority of the installment payments is less than five hundred dollars (\$500), a provision in the loan contract imposing a late payment charge is valid if it satisfies the requirements of Section 2954.5 and both of the following conditions:

(1) No late payment charge may be collected on an installment payment which is tendered or paid in full within 10 days after its scheduled due date even though an earlier maturing installment payment, or a late payment charge on an earlier installment payment, may not have been paid in full. For the purposes of this subdivision, an installment payment shall be considered paid as of the date it is received by the lender and, unless the borrower otherwise directs at the time the installment is paid, payments shall be applied first to current installment payments and then to delinquent installment payments.

(2) The amount of the late payment charge shall not exceed 10 percent of the amount of principal and interest included in the installment payment except that, where the amount of principal and interest included in the installment payment is less than fifty dollars (\$50), a charge not to exceed five dollars (\$5) or 20 percent of the amount of principal and interest included in the installment payment, whichever is the lesser amount, may be made.

(d) If the late payment charge referred to in subdivision (c) is not paid within 40 days from the scheduled due date of the delinquent installment payment for which the charge was imposed, the lender may, at his option, add the late payment charge to the principal and thereafter charge interest on it at the contract rate. If the lender elects to add the late payment charge to principal, he cannot thereafter treat the failure to pay the late payment charge as a default.

(e) This section limits only the obligation of a borrower to pay a late payment charge. Nothing in this section excuses or defers the borrower's performance of any other obligation incurred in the loan transaction, nor does this section impair or defer the right of the lender to enforce any other obligation, including but not limited to, the right to recover costs and expenses incurred in any enforcement proceeding authorized by law.

(f) This section does not apply to loans made by a credit union subject to the provisions of Division 5 (commencing with Section 14000) of the Financial Code, by an industrial loan company subject to the provisions of Division 7 (commencing with Section 18000) of the Financial Code, or by a personal property broker subject to the provision of Division 9 (commencing with Section 22000) of the Financial Code.

Cal. A.B. 105, Reg. Sess. (1973), introduced by Assemblyman Deddeh at the 1973 session, proposes that a maximum charge of ten percent be imposed on late installment payments due on a loan secured by a mortgage or deed of trust on real property containing only a single-family, owner-occupied dwelling. It would also prohibit late charges from being imposed more than once for the same late payment of an installment and from being imposed on any installment which is paid or tendered in full when due even though an earlier maturing installment or late charge on an earlier installment may not have been paid in full when due. Cal. A.B. 105, Reg. Sess. (1973).

plied to earlier, past-due installments and to late charges already incurred. Thus, despite failure by the borrower to meet previous payment deadlines, he will not be assessed for late charges on a current installment if he makes a timely payment of the full amount of that installment.¹³¹

The proposed statute sets a maximum limit on the amount assessed against a lender for each delinquency of ten percent of principal and interest due on the particular installment. If, however, the amount of principal and interest owed for the installment is less than fifty dollars, the lender may impose a late charge of five dollars or twenty percent of the principal and interest, whichever is the lesser of the two.¹³² The statute would give the lender an option to add a late-payment charge to the principal of the loan and charge interest on the sum at the contract rate if the borrower fails to pay the charge within forty days from the scheduled due date of the delinquent installments for which the late charge was assessed.¹³³

In its comment to the late-charge proposal, the Law Revision Commission indicates its desire to set forth clear and definite rules to overcome "uncertainty" regarding the use of late charges in loan contracts as a result of the *Garrett* decision. The comment indicates that the new statutory requirements for late charges on loans may not be avoided by labeling the payment of such charges as interest under the contract.¹³⁴ The comment also indicates that assessment of a late charge will have to meet the statutory prerequisites for imposition of a delinquent payment charge.¹³⁵ Finally, the comment stipulates that a properly-

131. CRLC, *supra* note 118, at 1215.

132. *Id.* at 1216.

133. *Id.*

134. *Id.* at 1220.

135. *Id.* at 1221; CAL. CIV. CODE § 2954.5 (West Supp. 1974), which provides in part:

(a) Before the first default, delinquency, or late payment charge may be assessed by any lender on a delinquent payment of a loan, other than a loan made pursuant to Section 22466 of the Financial Code, secured by real property, and before the borrower becomes obligated to pay such a charge, the borrower shall either (1) be notified in writing and given at least six days from mailing of such notice in which to cure the delinquency, or (2) be informed, by a billing or notice sent for each payment due on the loan, of the date after which such a charge will be assessed.

The notice provided in either paragraph (1) or (2) shall contain the amount of such charge or the method by which it is calculated.

(b) If a subsequent payment becomes delinquent the borrower shall be notified in writing, before the late charge is to be imposed, that the charge will be imposed if payment is not received, or the borrower shall be notified at least semiannually of the total amount of late charges imposed during the period covered by the notice.

(c) The failure of the lender to comply with the requirements of this section does not excuse or defer the borrower's performance of any

assessed late charge shall be considered valid unless the borrower can prove that it was unreasonable at the time the contract was made.¹³⁶

How does the new legislative proposal compare to the requirements for a valid late charge suggested by the *Garrett* court? Both reject the doctrine of alternative performance as a means for characterizing late interest charges to avoid statutory controls on liquidated damages.¹³⁷ The *Garrett* opinion indicated that the actual damages borne by the lender may be determined by the amount of the installment payment, the period during which the payment was wrongfully withheld, and the reasonable cost of administrative procedures resulting from the delinquency.¹³⁸ The legislative proposal would impose a maximum charge of ten percent of the principal and interest due on the installment in question in the event that the borrower fails to pay within ten days of the scheduled date of payment.¹³⁹ Additionally, the proposal would permit late charges which have not been paid within forty days of the date on which they accrued to be added to the principal of the loan and to produce interest at the contract rate. It may be argued that this type of calculation provides convenience to the lender rather than protection to the borrower. The borrower achieves no more benefit by paying eleven days after the installment was due than by paying thirty-nine days after the due date, since the late charge is imposed automatically on the eleventh day following the due date. The plaintiffs in *Garrett* complained bitterly about this summary method of assessment.¹⁴⁰

The Law Revision Commission's proposed late-charge provision bears some resemblance to the delinquency charges provision¹⁴¹ of the Unruh Act.¹⁴² Both establish a ten-day grace period,

obligation incurred in the loan transaction, other than his obligation to pay a late payment charge, nor does it impair or defer the right of the lender to enforce any other obligation including the costs and expenses incurred in any enforcement authorized by law.

136. CLRC, *supra* note 118, at 1221.

137. See text accompanying notes 94-96 and 99 *supra*.

138. See text accompanying note 103 *supra*.

139. See text accompanying note 131 *supra*.

140. See text accompanying note 88 *supra*.

141. CAL. CIV. CODE § 1803.6 (West 1970), which provides:

A contract may provide for the payment by the buyer of a delinquency charge on each installment in default for a period of not less than 10 days in an amount not in excess of 5 percent of such installment or five dollars (\$5), whichever is less, but a minimum charge of one dollar (\$1) may be made. Only one such delinquency charge may be collected on any such installment regardless of the period during which it remains in default. The contract may also provide for payment of any actual and reasonable costs of collection occasioned by removal of the goods from the State without written permission of the holder, or by the failure of the buyer to notify the holder of any change of residence, or by failure of the buyer to communicate with the holder.

both provide for calculation of the assessment as a percentage amount of the currently-owed installment payment, and both provide a further remedy for the lender when the borrower fails to take specified action for an extended period. The Commission's proposal may, however, have a significantly harsher economic effect on borrowers. The proposal would allow a maximum percentage figure for the purpose of calculating the late-charge assessment which is twice the maximum allowed under the Unruh Act.¹⁴³ The Unruh Act permits only one assessment of delinquency charges for an individual default, while the Commission's proposal would permit the lender to add amounts in default beyond forty days to the principal of the loan and to charge interest on such amounts at the contract rate after the lender has (presumably) already assessed a late-payment charge against the borrower.¹⁴⁴

One possible explanation for the discrepancies between the Commission's proposal and the Unruh Act is that the Commission may be attempting to include the elusive "motivation factor"¹⁴⁵ urged by lenders¹⁴⁶ in the late-charge calculation and assessment procedure. It may be recalled, however, that the lender in *Garrett* had collected nearly two million dollars in late-payment charges during the four years immediately preceding the plaintiffs' suit.¹⁴⁷ If motivation of timely payments was the purpose for assessing high late charges, it appears not to have had the desired effect; each of the affected borrowers in *Garrett* paid an average of nearly four hundred dollars in late charges during that period, which suggests *repeated* late payments rather than increased efforts to pay on time. The experiences of the borrowers in *Garrett* have convinced this writer that the "motivation" value of late-payment provisions in loan contracts is nominal and does not provide any rationale for *increasing* the amount of a late-charge assessment.

for a period of 45 days after any default in making payments due under the contract.

142. CAL. CIV. CODE § 1801 *et seq.* (West 1970).

143. Although the basic maximum percentage rate provided in the Commission's proposal is ten percent, the proposal would allow a higher figure, twenty percent or five dollars, whichever is less, to be used in calculating late-charge assessments when the installment is less than fifty dollars. CLRC, *supra* note 118, at 1219.

144. The delinquency charges provision of the Unruh Act (*see* note 141 *supra*) permits the seller to include a stipulated charge in the installment sales contract for actual collection costs related to obtaining payments which are more than forty-five days late. This stipulation, however, seems more analogous to foreclosure costs than to the Commission provision for adding specified late-charge assessments to the loan principal.

145. *See* text accompanying notes 109-14 *supra*.

146. *See* notes 111-12 and accompanying text *supra*.

147. *See* text accompanying notes 1-2 *supra*.

CONCLUSION

The situation faced by the *Garrett* court in 1973 indicates that slavish adherence to *stare decisis* may sometimes produce unfortunate results. The *O'Connor* and *Walsh* courts may be fairly criticized for failing to consider differences between the factual situations in *Thompson* and *Finger* and their own.

The *Garrett* court was able to comprehend these differences and to dismiss the theory of alternative performance in the loan installment context as a sham which served no purpose other than to circumvent legislative prohibition of contractual penalties. Apparently, the *Garrett* decision has reached receptive ears.

Despite the California Law Revision Commission's tendency to favor lenders rather than borrowers in its late-charge proposal, the proposal arguably falls within the *Garrett* guidelines for assessment of late fees: it is a reasonable sum based on the amount of the individual installment. For this reason, passage of the Commission's late-charge proposal in its present form would appear acceptable to the *Garrett* court and a step forward for small borrowers.¹⁴⁸

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148. In May, 1974, the California State Senate dropped Senate Bill 1532 after the California Law Revision Commission withdrew its support for the measure. The Commission decided to give the subject of liquidated damages and late-payment fees further study after numerous influential groups, including the Board of Governors of the State Bar and the Western Center on Law and Poverty, expressed opposition to the proposed changes. Copies of several of the letters received by the Commission are on file in the office of the *Santa Clara Lawyer*.