



Parties Cannot Waive California's Prohibition on Unenforceable Penalties

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When the borrower failed to make a payment within the time period specified in the settlement agreement (after having made the payments on time for over a year), the lender had a default judgment entered in the amount of \$58,829.35, \$58,101.85 of which were “punitive damages.” Based on the language of the settlement agreement and related stipulation, the borrower appeared to have little recourse since he had waived his right to contest the liquidated damages clause. However, contracting parties cannot easily escape California’s public policy against unreasonable penalties. Here was no exception.

The borrower moved to have the stipulated judgment vacated, relying on California Civil Code 1671(b) to argue that the stipulated default judgment constituted an unlawful penalty. The trial court agreed, finding that the damages did not bear any rational relationship to the damages the lender would actually suffer as a result of the borrower’s breach of the stipulation, and that the borrower’s waiver of the right to challenge the stipulation was unenforceable as against public policy. The Court of Appeal affirmed the trial court’s judgment, highlighting that: (i) “[t]he stipulation bore no reasonable relationship to the damages that it could be expected that [the lender] would suffer as a result of a breach by [the borrower],” (ii) “the language in the stipulation seeking to tie the \$85,000 to the economics of proceeding further with the matter was an obvious attempt to circumvent the public policy expressed in Section 1761,” and (iii) such “. . . public policy may not be circumvented by words used in a contract.”

In short, California’s public policy against unenforceable penalties will be strictly enforced by California courts. California views liquidated damages clauses that bear no reasonable relationship to the actual damages that could potentially arise from breach as unenforceable

penalties. Moreover, the burden of proving the reasonableness of the liquidated damages clause is on the party seeking the benefits of such clause, who must “plead and prove that the clause is valid under the facts which then existed.”

If you are negotiating a contract that will include liquidated damages, you should document the facts as of the time the contract is entered into that evidence that the liquidated damages provision bears a reasonable relationship to the damages the parties anticipated would result from a breach as of such time, including projected attorneys’ fees, costs of collection and other relevant potential costs.

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