



FENWICK & WEST LLP

Litigation Alert

California Court Enforces Liquidated Damages in Standardized Form Contracts for Consumer Services

JANUARY 27, 2006

On January 20, 2006, a California Court of Appeal found enforceable the liquidated damages provisions for late fees in standardized form contracts for consumer services.

Background

In *Utility Consumers' Action Network, Inc. v. AT&T Broadband of S. Cal., Inc.*, 06 C.D.O.S. 630 (Cal. App. 2d Dist. Jan. 20, 2006), a nonprofit consumer advocacy group filed an unfair competition action against numerous cable internet service providers. The plaintiff alleged that the late-fee liquidated damages provisions in defendants' standardized form service contracts were invalid because the defendants had not individually negotiated those provisions with each of their more than half-a-million customers. That is, the \$4.75 late fee was unilaterally set by the defendants and not the result of mutual negotiations between the defendants and their individual subscribers. The trial court granted defendants' summary judgment motion, and the Court of Appeal affirmed.

The Liquidated Damages Provisions

The late fee provisions stated that the subscribers agreed to pay any fees or charges, including administrative late fees, charges, and assessments. The agreements stated that charges for late payment and nonpayment were "liquidated damages intended to be a reasonable advance estimate of our costs resulting from late payments or non-payments by our customers, which costs will not be readily ascertainable, and will be difficult to predict or calculate, at the time that such administrative late fee(s) and related charges are set because it would be difficult to know in advance: (a) whether you will pay for the Service on a timely basis, (b) if you do pay late, when you will actually pay, if ever, and (c) what costs we will incur because of your late payment or non-payment. . . ." They also provided that the amount of those fees and charges would be posted at defendants' website or would be mailed to subscribers before any late fees were charged. The late fee did not exceed \$4.75.

For purposes of the summary judgment motion, the parties made several stipulations. First, the amount of the late fee

was reasonable. Second, it was impracticable or extremely difficult to fix ahead of time the actual costs of collecting late payments by individual subscribers. Third, defendants notified their subscribers of the late fee provision before service began, and they also gave notice of the amount of the late fee before it was imposed. Fourth, defendants performed an analysis to determine their actual late payment costs, and, according to that analysis, those costs were greater than the \$4.75 late fee.

The Decision

The trial court ruled that "where a liquidated damages clause was included in a pre-printed, form contract, the law applicable to contracts for the sale of consumer goods and services does not require both parties to actually negotiate the amount of liquidated damages. Instead, so long as the party who presented the form contract had made a reasonable endeavor to determine the amount of such damages, the provision was valid." The appellate court affirmed this reasoning and the summary judgment:

Liquidated damages do serve an important function. They remove the uncertainty factor from determining damages from a breach of contract and reduce litigation. Requiring a large enterprise to negotiate the terms of a late fee provision with thousands or hundreds of thousands of potential customers would effectively make it impossible to provide for late fees, even when they are warranted by the impracticability of determining damages and even when the amount selected by the business was designed to do no more than cover its damages and bore the proper relationship to the amount of such damages. We refuse to endorse such an interpretation of the reasonable endeavor requirement.

Practical Impact

The *Utility Consumers' Action Network* case focused on whether businesses must negotiate liquidated damages clauses individually with each consumer. It held that businesses do not.

Liquidated damages clauses must still meet several other requirements in California to be enforceable. Since 1978, California law has favored liquidated damages except in (a) contracts for the sale or lease of consumer goods and services; and (b) residential leases. In most non-consumer contracts, liquidated damages provisions are 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. Cal. Civ. Code § 1671.

By contrast, in residential leases and consumer contracts such as the ones in the *Utility Consumers' Action Network* case, there is a two-part test for determining the validity of liquidated damages. First, fixing the amount of actual damages must be impracticable or extremely difficult. Second, the amount selected must represent a reasonable endeavor by the parties to estimate fair compensation for the loss sustained. "Determining whether a reasonable endeavor was made depends upon both (1) the motivation and purpose in imposing the charges and (2) their effect. If the amount selected is designed to substantially exceed the damages suffered, and its primary purpose is to serve as a threat to compel compliance through the imposition of charges bearing little or no relationship to the amount of actual loss, then the purported liquidated damages provision is an invalid attempt to impose a penalty."

The *Utility Consumers' Action Network* case clarified that the "reasonable endeavor test" does *not* require negotiation by both contracting parties. That is, businesses can unilaterally set the amount of liquidated damages based on an estimation of fair compensation for the loss sustained and determine the amount of liquidated damages so long as that calculation is reasonable.

In sum, this ruling makes it easier for businesses to include reasonable liquidated damages provisions in consumer contracts.

If you have questions about the issues raised in this alert, please contact:

Patrick E. Premo , Partner, Litigation Group
ppremo@fenwick.com, 650-335-7963

Karen P. Anderson, Senior Associate, Litigation Group
kanderson@fenwick.com, 650-335-7105

THIS UPDATE IS INTENDED BY FENWICK & WEST LLP TO SUMMARIZE RECENT DEVELOPMENTS IN THE LAW. IT IS NOT INTENDED, AND SHOULD NOT BE REGARDED, AS LEGAL ADVICE. READERS WHO HAVE PARTICULAR QUESTIONS ABOUT THESE ISSUES SHOULD SEEK ADVICE OF COUNSEL.
