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California Court Invalidates Liquidated Damages Provision in Credit Card Agreement

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by David Weissman

In ***Hitz v. First Interstate Bank*, 44 Cal. Rptr. 2d 890 (Cal. Ct. App. 1995),** the California Court of Appeal held that Civil Code section 1671, subdivision (d) ("§ 1671(d)"), invalidates the liquidated damages clause in a credit card agreement when the amount of those damages does not represent a "reasonable endeavor" to estimate potential loss resulting from a breach of the agreement. However, the court also held that the credit card-issuing bank is entitled to its actual damages resulting from the breach based on the interest rate established in the credit card agreement.

Class action plaintiffs awarded nearly $14 million at trial

This suit was initiated by credit card customers of First Interstate Bank (the "Bank") who breached their credit card agreements by failing to make timely minimum monthly payments or by exceeding their credit limits. The trial court certified these plaintiffs as a class, consisting of the Bank's cardholders who were assessed late or overlimit fees after February 10, 1983. The plaintiffs argued at trial that the Bank's fees were void under § 1671(d) as invalid liquidated damages. After a bench trial, the trial court ruled in favor of the plaintiffs, awarding the class a judgment of $13,971,830.

On appeal, the California Court of Appeal agreed with the trial court's determination that § 1671(d) invalidated the liquidated damages in the form of late and overlimit fees, which were imposed by the Bank. However, the court modified the judgment to reflect the Bank's actual damages resulting from the cardholders' breach of the credit card agreements. The court held that these damages consisted of the interest on the plaintiffs' late and overlimit balances assessed at the contract (credit card agreement) rate.

Court of appeal finds error in computation of defendant's actual damages

The court first addressed the issue of the Bank's actual damages. The trial court had calculated these damages by looking at the Bank's cost of borrowing the funds to pay the cardholders' late and overlimit balances. The trial court based this cost on the average federal funds interest rate, which is the rate that the Bank had to pay to obtain the money from the reserves of other banks in order to cover the costs incurred from the plaintiffs' breaches. Because the Bank had charged the cardholders the rate of interest established by the credit card agreement, a higher rate than the federal funds interest rate, the trial court awarded the plaintiffs the difference between these two amounts. In other words, the trial court returned to the plaintiffs the amount the Bank had collected from them above what it considered the Bank's actual damages to be.

The court of appeal, however, cited several reasons why this calculation of the Bank's actual damages was in error. First of all, the court looked to statutory language and precedent for the proposition that interest is to be charged at the rate agreed upon in a contract after a breach of that contract. Civil Code section 3298, subsection (a), "specifically provides for interest to continue at the rate stipulated to by the contract," according to the court. Also, the California Supreme Court case of *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.*, 511 P.2d 1197 (Cal. 1973), discussed "the fixed nature of damages resulting because of the wrongful withholding of money."

The court of appeal pointed out the possible anomalous results of the trial court's application of the federal funds interest rate to the late and overlimit balances, in that "delinquent cardholders would pay less on their delinquent balances than nondelinquent cardholders would pay on their nondelinquent balances." The court further noted that such a rule could then be applied to commercial loans in general, creating confusion and uncertainty for borrowers and lenders alike.

The trial court's second error, according to the court of appeal, was accepting the plaintiffs' theory that their breach of the credit card agreement conferred a benefit upon the Bank, enabling it to collect additional interest on the late and overlimit portions of the cardholders' outstanding balances. The plaintiffs further argued that this benefit to the Bank was available only because of the breach, and represented amounts the Bank would not have collected absent the breach. Contract law says that gains made by the injured party after a breach are not deducted from that party's damages unless those gains could not have been made had there been no breach. 5 Corbin On Contracts 256, § 1041. Therefore, the trial court deducted the additional finance charges created by the cardholders' breaches from the Bank's actual damages.

The court of appeal rejected this determination. Because the Bank could have used the money that financed the plaintiffs' late and overlimit balances to make loans to other customers had the breach never occurred, the court held that the Bank's gain was not made possible only by the plaintiffs' breach. Thus, the inclusion of the Bank's gains from the interest on the plaintiffs' late and overlimit balances was incorrectly added to the plaintiffs' recovery.

The final error by the trial court, according to the court of appeal, was its incorrect determination of the benefit conferred upon the Bank. The trial court felt this benefit was the difference between the interest earned at the rate in the credit card agreement and the cost of funds at the federal funds rate. The court of appeal held that in determining the Bank's benefit, the costs "directly related to extending credit" must be included in addition to the cost of federal funds. While the court does not say specifically what these costs are (the trial court had described these costs in its statement of decision), it does note that the costs of extending credit are separate and distinct from administrative costs.

Liquidated damages questioned under statutory provisions

While the court of appeal modified the trial court's assessment of the Bank's actual damages, the court did agree with the trial court's decision that the Bank was precluded by § 1671(d) from collecting liquidated damages as a result of the plaintiffs' breach. The first issue the court discussed in this regard was which standard for determining the validity of the liquidated damages provision to apply — that established in Civil Code section 1671, subdivision (b), or subdivision (d).

Under subdivision (b), the liquidated damages provision in a contract is presumed to be valid, and the burden is placed on the party opposing the provision to show it was unreasonable under the circumstances when the contract was formed. Subdivision (d), on the other hand, says that the provision:

> "is void except that the parties to such 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 the case, it would be impracticable or extremely difficult to fix the actual damage."

In order to decide which subdivision to apply, the court looked to Civil Code section 1671, subdivision (c), which establishes when subdivision (d), rather than subdivision (b), shall apply. Subdivision (c)(1) says that subdivision (d) should be applied in determining the validity of a liquidated damages provision when the liquidated damages are sought to be recovered from a party to a contract for the purchase or rental of personal property or services. Because a credit card agreement is a contract for services, the court held that subdivision (d) applies to the contract at issue.

While the Bank argued that a credit card agreement is a contract for the extension of credit, not services, the court rejected this position. In addition to the extension of credit, the court found credit cards offer customers "convenience services" such as minimizing the need to carry cash and checks and establishing a favorable payment record. The Bank further argued that late and overlimit charges only relate to the extension of credit aspect of the agreement, not to the service component. The court was not persuaded, holding that a cardholder could make use of either aspect of the agreement at any time, and thus found the agreement to be in part a "contract for the retail purchase of services" in relation to all cardholders. Thus, the court concluded that § 1671(d) applies.

Liquidated damages provision held invalid

Having decided to apply § 1671(d), the court next laid out the test for when liquidated damages are valid under this subdivision. This test consists of two elements which must be satisfied. First, it must have been "impracticable or extremely difficult to fix the actual damage." Civil Code § 1671(d). Second, the amount of the damages "must represent the results of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained." *Garrett v. Coast & Southern Fed. Sav. & Loan Assn.*, 511 P.2d 1197 (Cal. 1973). If either of these elements is not met, the liquidated damages provision is void, and the breaching party is liable only for the actual damages which result from the breach.

The court first looked at the "reasonable endeavor" test. The court again cited to the *Garrett* decision, which says that a court must look to a party's motivation and purpose in imposing the liquidated damages. While the Bank argued that its purpose was merely to recoup its cost, there was much evidence at trial which indicated that the Bank intended to generate profits through its late and overlimit fees, profits designed to exceed the actual damages suffered. The court of appeal held that the trial court had adequately weighed the evidence on this issue, and refused to question the trial court's decision that the Bank's motivation was to generate profits above and beyond its actual loss.

In making its decision that the Bank had not made a reasonable endeavor to estimate loss, the trial court was persuaded by the fact that the Bank had undertaken no form of analysis to determine its potential losses from a breach. The Bank argued that this represented error, because the law does not require a formal analysis or cost study. The court of appeal found no error, explaining that the trial court had not required a cost study per se, merely "some form of analysis." The court supported this requirement by the trial court, stating that an estimate of loss "cannot occur without some sort of analysis of the loss that is to be compensated."

As the court of appeal found no error in the trial court's ruling on the "reasonable endeavor" issue, it did not examine the impracticability issue. Because the Bank did not make a reasonable endeavor to estimate the loss resulting from a breach, the court affirmed the ruling that the liquidated damages provision in the credit card agreement was void under §1671(d). The court thus upheld that portion of the plaintiffs' judgment which represented the fees collected as liquidated damages.

Case closes a chapter in credit card fee litigation

In sum, the California Court of Appeal reduced the $13,971,830 judgment for the plaintiffs by $9,076,304, which represented the Bank's actual damages. Nevertheless, the court upheld the remaining $4,895,526 of the judgment, representing invalid liquidated damages that the Bank assessed upon the plaintiffs in the form of late and overlimit fees for their breach of the credit card agreement. However, the court noted in conclusion that new legislation expressly permits credit card issuers to impose late and overlimit fees of certain amounts. Fin.Code, § 4001, subd. (a). Thus, this case "appears to close a chapter in credit card fee litigation."

Departure from established tort theories inappropriate for breast implant litigation

by Dana Shannon

The court in ***In re New York State Silicone Breast Implant Litigation*, 631 N.Y.S. 2d 491, 166 Misc. 2d 85 (1995)**, held that the plaintiffs' claim for market share liability is inapplicable to breast implants since manufacturers are generally ascertainable, and all manufacturers' products are not identical. Additionally, the court held that the plaintiffs' claim for concert of action liability is inappro-