Hon. Abraham Khan (Ret.)
SIGNATURE RESOLUTION

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# Don’t let a liquidated-damages clause nullify your settlement agreement

## WHEN A SETTLEMENT AGREEMENT INCLUDES A LIQUIDATED-DAMAGES PROVISION IT MAY BECOME SUBJECT TO HEIGHTENED SCRUTINY

When legal matters are settled by disputing parties through mediation outside of the courtroom, it is generally cause for celebration. Instead of lengthy proceedings, jury selection, rules of evidence, witness testimony, judicial orders, and countless other challenges inherent in litigation, the parties ultimately retain control of their case and arrive at a resolution upon which they both can agree. When they sign their settlement agreement, they understand that the case is completely closed and that they can move on with their lives.

But imagine a different scenario. What if, instead of an enforceable agreement reflecting the parties’ compromises and concessions, the settlement is found to be invalid and unenforceable? That case – upon which all parties expended considerable effort toward achieving closure – is now essentially unresolved, and the parties are suddenly back at square one.

It could happen more easily than many practitioners realize. When a settlement agreement negotiated during a mediation includes a liquidated-damages provision – not an uncommon element of many contracts – it may become subject to heightened scrutiny. If that provision is not carefully drafted, it could end up invalidating the underlying agreement.

### Defining liquidated damages

Liquidated damages are a fixed amount, established within the terms of an agreement, that is to be paid to one party by the other party after they have breached a term of the contract. Such damages are the sole and exclusive remedy for the party’s breach of that particular term of the contract. The intent of liquidated damages is to compensate the non-breaching party for injury sustained as a result of the breach.

Generally, such damages will come up during a mediation session when it is difficult to estimate the amount of actual damages a party might suffer when a specific term has been breached. For purposes of this analysis, we will focus on cases settled through mediation in which one party has agreed to pay the other a mutually stipulated amount. The liquidated-damages clause is invoked when the first party defaults or is late on its payment obligation and the second party is injured by the debtor’s failure to pay what is owed.

Liquidated damages are typically of a size that will effectively dissuade the other party from even considering breaching the agreement. When done correctly, a liquidated-damages clause should prevent a party from breaching the terms of the contract. If that party nevertheless chooses to violate those terms, however, the other party should essentially be made whole. For parties working toward settling a seemingly intractable dispute, liquidated damages can provide the assurance they need that their agreement will be honored.

### Liquidated damages in mediation settlement agreements

In many mediations, parties are working toward settlement of outstanding obligations. One party owes the other party money, is liable for the other’s loss or injury, or otherwise is in debt to the other party. The parties negotiate a compromise that will address the obligation, as well as the terms of payment of the amount owed.

The mediator’s job is to help the parties arrive at such a compromise by establishing an amount that satisfies the creditor’s demands while providing a realistic repayment plan for the debtor. The settlement agreement will thus set forth the amount of the obligation, the payment schedule, a definition of what constitutes a breach, and the remedies available to the creditor in the event of breach by the debtor.

Those remedies are likely to include liquidated damages that must be paid by the debtor if it fails to satisfy its payment obligations. Such provisions may be enforceable for mediated cases that have been filed in the Superior Court via a stipulation for entry of judgment. In order for the settlement agreement to be admissible in court, it must comply with the terms of Evidence Code section 1123, which requires signature of the parties *and* words to the effect that it is “admissible or subject to disclosure” and is “enforceable or binding,” as well as express agreement by all parties to its disclosure.

Enforcement is generally accomplished under an agreement by the parties that the court in which the action is pending has authority to retain jurisdiction over the case under Code of Civil Procedure section 664.6. Without needing to file a new action, the court is then empowered to enforce the settlement terms, including the “entry of judgment.”

When the mediation settlement agreement is not filed with the court, the parties can agree between themselves that disputes concerning the enforcement of the settlement agreement can be resolved by the mediator and/or through arbitration. Although there are no specific statutory time limits governing the entry of a judgment upon default or failure to comply with the settlement agreement, the parties can include time boundaries in the remedy section of their agreement.

### Law of liquidated damages

California law has long focused on

the validity of liquidated damages provisions in contracts. In 1872, former Civil Code section 1670 was enacted, stating that a liquidated damages provision was "void" unless it complied with former section 1671.

That changed in 1977, when section 1671 was amended to address non-consumer contracts. Section 1671, subdivision (b) now provides that, when non-consumer agreements are at issue, "a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."

Section 1671, subdivision (c), which deals with consumer contracts, continues to look askance at liquidated-damages clauses. The law states that where liquidated damages are sought to be recovered from either a "party to a contract for the retail purchase, or rental, by such party of personal property or services, primarily for the party's personal, family, or household purposes" or by a "party to a lease of real property for use as a dwelling by the party or those dependent upon the party for support," the validity of the liquidated damages provision is determined under section 1671, subdivision (d).

That subsection effectively voids liquidated-damages provisions unless the parties to the contract "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."

## Damages vs. penalty

Liquidated damages are, as the name suggests, intended to compensate a victim of breach of contract. The reason parties negotiate them as part of their agreements is to ensure that the non-breaching party is made whole in the event the other party fails to comply with a term of the contract. Agreed-upon damages are attempts to rectify a problem created by the party who breached the contract.

In contrast, penalty clauses have a different intent and purpose. They are included not to correct a wrong but to impose punishment upon a party for its actions. As a punitive measure, their primary purpose is to exact the "pound of flesh" that the non-breaching party feels is its due. Penalties are thus unlikely to correspond in any meaningful way to the actual amount of the injury suffered by the non-breaching party.

Civil Code section 1671 does not support the imposition of penalties for breach of contract. Additionally, punitive damages are not recoverable in breach-of-contract actions. (*Myers Building Industries, Ltd. v. Interface Technology, Inc.* (1993) 13 Cal.App.4th 949, 960.) Thus, when liquidated damages are found to be merely a surrogate for penalties, they will not be upheld.

## Reasonableness of the liquidated-damage amount

California law has generally disfavored contractual liquidated-damages provisions unless they reflect a reasonable estimate of potential future damages under the circumstances in effect at the time the contract was formed. The party challenging the contractual provision, however, bears the burden of proving the provision is unreasonable.

When drafting a liquidated-damages clause within a settlement agreement, there must therefore be a reasonable relationship between the damages that could have been anticipated based on a failure to pay the settlement amount when due and the amount established as the default judgment. Several cases underscore the significance of this relationship between the underlying debt and the damages owed for nonpayment.

In *Greentree Financial Group Inc. v. Executive Sports, Inc.* (2008) 163 Cal.App.4th 495, a stipulated judgment of $45,000 was found to constitute an unenforceable penalty where the underlying settlement was for $20,000. The court explained that under section 1671(b), a liquidated damages clause constitutes an unenforceable penalty "if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach. The amount set as liquidated damages 'must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained.' [Citation] In the absence of such a relationship, a contractual clause purporting to predetermine damages 'must be construed as a penalty.'"

In *Purcell v. Schweitzer* (2014) 224 Cal.App.4th 969, the parties had reached settlement of a dispute over nonpayment of a promissory note. The defendant had agreed to pay $38,000, along with interest at the rate of 8.5 percent, in installments over 24 months. Payments were due on the first day of each month and had to be received no later than the fifth day of the month. The agreement provided that if a payment was not made on time, it was considered a breach of the entire settlement agreement, making the entire original liability of $85,000 due. The agreement also specified that that provision did not constitute an unlawful "penalty" or "forfeiture."

When Schweitzer was late on a payment, Purcell sought and was granted a default judgment in the amount of $58,829.35. Despite the language of the parties' agreement, the appellate court found the default judgment to be unsupportable. It ruled that "the public policy expressed in Civil Code sections 1670 and 1671 *may not be circumvented by words used in a contract*." Citing *Ridgley v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970, 977, the court held that a liquidated-damages clause becomes an unenforceable penalty "if it bears no reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach."

Finally, in the case of *Vitatech Internet, Inc. v. Sporn* (2017) 16 Cal.App.5th 796, a stipulated judgment of $303,000 for the defendant's failure to timely pay $75,000

Journal of Consumer Attorneys Associations for Southern California
ADVOCATE
September 2023

was struck down by the court as an illegal "liquidated damage." At four times the amount owed, the court said that such a stipulated late fee was a "penalty."

### Parties' bargaining position

Whether the amount of liquidated damages reflects a reasonable estimate of actual damages is, however, just one of the factors courts must consider when determining whether the provision is unreasonable. Courts are also directed to look at the circumstances existing at the time of the making of the contract. They must consider the relative equality of bargaining power between the parties, whether the parties were represented by lawyers at the time the contract was made, and whether the liquidated damages are part of a form contract.

In the recent case of *Gormley v. Gonzalez* (2022) 84 Cal.App.5th 72, the court found in favor of the party seeking to enforce the liquidated-damages provision in a settlement agreement. It relied on the California Law Revision Commission's commentary on section 1671(b) to note that for non-consumer contracts such as the settlement agreement in this case, that law created "a new general rule favoring the enforcement of liquidated damages provisions."

While acknowledging that liquidated damages must still bear a reasonable relationship to underlying damages in consumer contracts, the court dispensed with this analysis for non-consumer transactions. It again cited the Law Revision Commission: "This new statutory provision would reverse the basic disapproval of liquidated damages provisions expressed in sections 1670 and 1671 and in the judicial decisions. Under the new provisions, parties with relatively equal bargaining power would be able to develop and agree to a reasonable liquidated damages provision with assurance that the provision will be held valid."

In rendering its opinion, the *Gormley* court highlighted the fact that the "settlement was negotiated with the assistance of counsel and after numerous drafts were exchanged between the parties and the liquidated damages provision in particular involved significant negotiations." The defendants, the court observed, were only partly insured with a "burning limit insurance policy," causing the plaintiff to substantially discount its case value in reliance on the defendant's assurance that it could only pay a far smaller amount. The parties mutually agreed that the trial value of the case was $1.5 million. To incentivize prompt payment, they mutually stipulated to a liquidated-damages provision capped at the $1.5 million amount.

Unlike the courts in *Greentree*, *Purcell* and *Vitatech*, the court in *Gormley* found relevant the amount the plaintiff claimed could have been recovered had the case proceeded to trial. In conducting their damages analysis, the justices expressly looked beyond the non-payment provision in the underlying settlement agreement. They distinguished the case before them from the *Greentree* and *Vitatech* cases, whose records were silent on the likely damages recoverable at trial. In contrast to those cases, the judges noted, the record in *Gormley* reflected a clear agreement between the parties that damages of at least $1.5 million were likely recoverable if the case proceeded to trial. The court found this fact, among other factors raised at trial, to be compelling.

The court effectively dismissed the defendants' reliance on the 1998 *Ridgley* decision. "We are not convinced that *Ridgley* creates a rule that allows a defendant in a lawsuit – particularly one who is represented by counsel – to actively negotiate a settlement agreement with a liquidated damages clause (and thus to effectively halt the plaintiff's prosecution of the case), to default on that agreement, and then to resist entry of judgment by arguing the clause is invalid because the damages it agreed to are too high. Put another way, we are not convinced that *Ridgley* creates a rule that allows represented defendants to assert what might be called the 'hey neener neener, gotcha sucker' defense."

In another recent case, *Constellation-F, LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22, the court found that a holdover provision in a commercial lease providing for significantly increased rents during the holdover period was not an unenforceable penalty under Civil Code section 1671. Although the decision, supporting a 150% base rent increase in the event of failure to vacate the premises dealt with holdover provisions in commercial leases, its broad language focused on the contracting parties' respective bargaining powers. It may therefore be read to implicate other contractual relationships, including consumer agreements.

### Conclusion

As the case law demonstrates, failure to carefully craft a liquidated-damages provision in a mediation settlement agreement can invalidate the entire agreement. Counsel should therefore take care to negotiate liquidated damages that bear a reasonable relationship to the actual injury a party would be expected to suffer if the other party failed to timely pay amounts due under the agreement. Amounts that far exceed the underlying obligation could well invite judicial scrutiny. Any liquidated-damages clause that fails the reasonableness test is likely to be struck down as a penalty, rendering the entire mediation settlement agreement a nullity.

Additionally, given the holding in the recent *Gormley* case, parties mediating payment disputes should be conscientious about including in their settlement agreements representations concerning equal bargaining power and consideration of other alternatives. When counsel during a mediation is actively involved in negotiation of liquidated damages and carefully crafts the damages provision, the mediation settlement agreement has a greater likelihood of being found enforceable.

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*Hon. Abraham Khan (Ret.) is a neutral with* Signature Resolution, *focused on resolving business and commercial contracts, employment, real estate, entertainment industry, landlord/tenant, eminent domain, civil rights, and personal injury disputes. Prior to his retirement from the bench on March 1, 2020, he served more than 30 years on the Los Angeles Superior and Municipal Courts, the last six years as a full-time settlement conference judge handling complex and unlimited jurisdiction civil cases for the civil division at both the Stanley Mosk and Spring Street courthouses. For more than a decade, Judge Khan was a member of the Los Angeles Superior Court's arbitration/alternate dispute resolution committee and served as vice-chair of the committee. Contact: judgekhan@signatureresolution.com.*