

THURSDAY, NOVEMBER 30, 2023

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## Liquidated damages could undo a settlement agreement

By Hon. Abraham Khan (Ret.)

A settlement agreement is typically the capstone of a successful mediation. Parties in a legal dispute have worked with the mediator to negotiate a mutually agreeable resolution of their issues, and they are ready to leave the dispute behind them. Their agreement spells out the terms and conditions upon which they have agreed, including payment amounts and timing, as well as nondisclosure, nondisparagement and other important provisions.

For one side or the other, there may be concerns about the other party's compliance with the settlement terms. A liquidated damages provision could provide the assurance they need to move forward with the settlement. If their counterpart fails to timely pay what is owed or breaches another critical provision of the agreement, they will be on the hook for additional sums.

But the very term that provides this comfort could end up rendering the entire agreement invalid and unenforceable. When a settlement agreement negotiated at a mediation includes liquidated damages, it may face heightened scrutiny, and a poorly drafted liquidated damages provision could, in fact, invalidate the parties' entire agreement.

### Liquidated damages 101

Liquidated damages are a fixed amount 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.



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These damages generally come up in mediation when it's hard to estimate how much a party might suffer when a term is breached. They should effectively dissuade the other party from even considering breaching the agreement. For individual plaintiffs with limited budgets, liquidated damages usually achieve the desired result, but for large businesses, they may merely be an inconvenience. And herein lies the conundrum.

A good liquidated damages clause should prevent a party from breaching the terms of the contract. If he or she violates those terms, the other party should be made whole. For parties working toward settling a seemingly intractable dispute, this provides the assurance they need that the agreement will be honored.

But California law has long grappled with liquidated damages in contracts. Civil Code Section 1670, originally enacted in 1872, recognized liquidated damages provisions in consumer contracts only when certain conditions were met. Civil Code Section 1671, amended in 1977, added coverage for non-consumer contracts.

Under the law, liquidated damages in non-consumer contracts must be reasonable "under the circumstances existing at the time the contract was made." For consumer agreements, they are void unless the parties "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."

When dealing with deep-pocketed parties, however, the damages that will effect compliance with settlement terms could end up being far higher than the "amount of damage sustained by a breach thereof." No pain, no gain.

### Mediation settlement terms

Often parties in mediation are negotiating about outstanding obligations. One party owes the other party money, is liable for the other's loss or injury, or is in debt to the other party. The compromise they reach addresses the obligation, setting forth the amount of the obligation, the payment schedule, a definition of what constitutes a breach, and remedies available to the creditor in the event of breach. These remedies may include liquidated damages to be paid by the debtor.

In many mediations, one party is worried that the agreement or the facts underlying it will become public. It may insist on inclusion of a nondisclosure and/or nondisparagement clause in the settlement agreement, to bar the prevailing party from publicizing the existence and/or amount of the settlement, as well as any negative information about the party obligated to pay. In business-to-business and consumer disputes, such provisions are generally upheld and enforced.

Employers, however, face constraints when attempting to muzzle their workers. In California, SB 331 prohibits nondisclosure and nondisparagement clauses in all agreements signed on or after Jan. 1, 2022 unless they allow employees to discuss or disclose information about unlawful acts in the workplace, including possible harassment, retaliation, or discrimination. SB 820, the 2018 STAND Act, prohibits and invalidates any settlement agreements that seek to prevent the disclosure of factual information, documented in a claim filed in court or with an administrative agency, relative to sexual misconduct in the workplace.

Thus, liquidated damages cannot be used in all cases, even if they appear to be fair and properly crafted. When allowed, such damages should approximate the injury suffered by the non-breaching party to the agreement. For nonpayment of amounts owed, the harm is likely to be more quantifiable than when terms such as confidentiality or nondisparagement are breached. The actual injury suffered in these types of cases may not be fully known or appreciated at the time of the breach.

### Damages or penalty?

Parties negotiate liquidated damages to ensure that they will be made whole in the event the other party fails to comply with a critical term. Such damages are attempts to rectify a problem created by the party who breached the contract.

Penalty clauses, in contrast, 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. They are 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, and punitive damages are not recoverable in breach of contract actions. (See

*Myers Building Industries, Ltd. v. Interface Technology, Inc.* (1993) 13 Cal.App.4th 949, 960, 17 Cal. Rptr.2d 242.) Liquidated damages will not be upheld if they are merely a surrogate for penalties.

### Reasonableness

Liquidated damages in settlement agreements must, therefore, bear a reasonable relationship to the damages that could be anticipated based on a failure to pay the settlement amount when due or to adhere to other agreed upon terms.

In *Greentree Financial Group Inc. v. Executive Sports, Inc.* ((2008) 163 C.A. 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.” In the absence of such a relationship, “a contractual clause purporting to predetermine damages ‘must be construed as a penalty.’”

Even when the parties have stipulated that liquidated damages were not a penalty, courts have ruled otherwise. In *Purcell v. Schweitzer* ((2014) 224 C.A. 4th 969), the parties agreed 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. 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 agreement, the appellate court held that the default judgment was unenforceable because “the public policy expressed in Civil Code sections 1670 and 1671 may not be circumvented by words used in a contract.”

### Enforcement

Liquidated damages provisions may be enforceable when mediated cases are filed in the Superior Court via a stipulation for entry of judgment. Their agreement must comply with Evidence Code Section 1123, with 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 California 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.

### Bargaining position

In addition to the reasonableness of liquidated damages, courts may also look at the circumstances existing at the time of the making of the contract including 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 California Court of Appeals found in favor of the party seeking to enforce the liquidated damages provision in a settlement agreement. It noted that for non-consumer contracts such as the settlement agreement at issue, the 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 cited Civil Code Sections 1670 and 1671 to hold that parties with relatively equal bargaining power should be able to develop and agree to a reasonable liquidated damages provision with assurance that the provision will be held valid.

The court highlighted 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.” Unlike earlier courts, this court found relevant the amount the plaintiff claimed could have been recovered had the case proceeded to trial, looking beyond the non-payment provision in the underlying settlement agreement. The judges noted that the record reflected a clear agreement be-

tween the parties on the damages likely recoverable if the case proceeded to trial.

### Conclusion

Failure to carefully craft a liquidated damages provision in a mediation settlement agreement could end up invalidating the entire agreement. Parties and counsel should therefore negotiate damages that bear a reasonable relationship to the actual injury they would be expected to suffer if the other party failed to honor a term of the agreement.

Amounts that far exceed the underlying obligation could well invite judicial scrutiny. Any liquidated damages clause that fails the reasonableness test will likely be struck down as a penalty, rendering the entire mediation settlement agreement a nullity. Counsel should therefore be conscientious about including in settlement agreements representations concerning the equal bargaining power of the represented parties, the length and detail of negotiations – especially with respect to liquidated damages, consideration of alternatives, and other factors important to the process of reaching a full, fair, and well negotiated settlement.

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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, 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. 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.

