



Liquidated damages could nullify a settlement agreement

A REVIEW OF THE CIVIL CODE AND COURT DECISIONS THAT DEFINE THIS COMMON CONTRACT CLAUSE

A settlement agreement is typically the capstone of a successful mediation. Parties to a legal dispute have negotiated a mutually agreeable resolution of their issues, bypassing lengthy proceedings, jury selection, rules of evidence, witness testimony, judicial orders, and countless other challenges inherent in litigation. They have arrived at a resolution upon which they both can agree and are ready to leave the dispute behind them.

The settlement 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. When it is signed, both sides understand that their case is completely closed and that they can move on with their lives.

But if the agreement includes a liquidated-damages provision, all bets may be off. Instead of an enforceable agreement reflecting the parties' compromises and concessions, the entire settlement might be found to be invalid and unenforceable, putting the parties – who expended considerable effort toward achieving closure – suddenly back at square one.

Unfortunately, the very provision intended to provide assurance that the settlement will be honored could end up rendering the entire agreement invalid and unenforceable. A settlement agreement that includes liquidated damages could invite heightened scrutiny, and a poorly drafted liquidated-damages provision could end up invalidating the parties' entire agreement.

Why liquidated damages?

Liquidated damages are a common element of many contracts. One party may have concerns about the other party's willingness to comply with one or

more terms of the agreement, and a liquidated-damages provision can provide just the assurance they need that the terms will be honored or that, if breached, they will be made whole.

These damages generally come up in mediation when it is hard to estimate how much a party might suffer when a particular term is breached. They are a fixed amount, established within the terms of an agreement, that is to be paid to a party by the other party after they have breached a term of the contract.

Such damages are the sole and exclusive remedy for that party's breach of that particular term of the contract. The intent of liquidated damages is to compensate the non-breaching party for any injury they may have sustained as a result of the breach.

Liquidated damages are commonly found in nondisclosure agreements, but they are also used in rental, sales and services contracts, where the ramifications of a breach may be complex and multi-layered. For individual plaintiffs with limited budgets, liquidated damages usually achieve the desired result, but for large businesses, they may merely be an inconvenience.

Liquidated damages should be of a size that will effectively dissuade the other party from even considering breaching the agreement. If that party nevertheless chooses to violate those terms, the nonbreaching party will essentially be made whole. For parties working toward settling a seemingly intractable dispute, a liquidated-damages provision can be exactly the solution to finally get them to the finish line.

Law of liquidated damages

California law has long been leery of liquidated damages provisions in contracts. Former Civil Code section

1670, enacted in 1872, stated that a liquidated-damages provision was "void" unless it complied with former section 1671, which dealt only with consumer agreements.

In 1977, however, section 1671 was amended to address non-consumer contracts. Section 1671(b) now establishes a reasonableness standard for liquidated damages in such agreements. It provides that, for non-consumer agreements, "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(c) deals with consumer contracts, and it continues to look askance at liquidated-damages clauses in such agreements. 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 must be determined according to the terms of section 1671(d).

That section 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." When dealing with deep-pocketed parties, however, the damages that will be sufficient to ensure compliance with settlement terms could

end up being far higher than the “amount of damage sustained by a breach thereof.”

Mediation settlements

Parties in mediation are often negotiating about outstanding obligations. One party owes the other money, is liable for the other’s loss or injury, or is in debt to the other. Their settlement is intended to address this obligation by 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, which may include liquidated damages to be paid by the debtor.

In some mediations, one party may be worried about the agreement or the facts underlying it becoming public. A nondisclosure and/or nondisparagement clause will be included in the settlement agreement to bar the prevailing party from publicizing the existence and/or amount of the settlement, or from disclosing any negative information about the party obligated to pay. In business-to-business and consumer disputes, such provisions are generally upheld and enforced.

However, if the settlement addresses an employment dispute, other rules apply. In California, employers face restraints against muzzling their workers. SB 331 prohibits nondisclosure and nondisparagement clauses in 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, 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, even if they are properly crafted, liquidated-damages provisions cannot be included in all settlement agreements. And when they are allowed, they should approximate the injury

suffered by the non-breaching party to the agreement. For nonpayment of amounts owed, the harm is likely to be easier to quantify 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 vs. penalty

As the name suggests, liquidated damages are intended to compensate a victim of breach of contract. Parties negotiate them as part of their agreements 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.

Penalty clauses, in contrast, have a completely 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 it is 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

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 bears the burden of proving the provision is unreasonable.

When drafting a liquidated-damages clause within a settlement agreement, therefore, counsel should make sure that there is 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, the court found that a stipulated judgment of \$45,000 constituted an unenforceable penalty where the underlying settlement was for merely \$20,000. Under section 1671(b), the court said, 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 the 2014 case of *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 unenforceable. 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, the court struck down a stipulated judgment of \$303,000 for the defendant's failure to timely pay \$75,000. At four times the amount owed, the court said that such a stipulated late fee was a penalty.

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 Court of Appeal 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 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.

Dismissing the defendants' reliance on the *Ridgley* case, the court stated, "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 the case of *Constellation-E LLC v. World Trading 23, Inc.* (2020) 45 Cal.App.5th 22, a California appellate 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-percent 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.

Enforcement

Liquidated-damages provisions may be enforceable when mediated cases are filed in the superior court via a stipulation for entry of judgment. The 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 may be 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 enforcement of the settlement agreement may be resolved by the mediator and/or through arbitration. There are no specific statutory time limits governing the entry of a judgment upon default or failure to comply with the settlement agreement; however, the parties can include time boundaries in the remedy section of their agreement.

Conclusion

Liquidated-damages provisions can make or break a mediation settlement agreement. Counsel should therefore

ensure that they bear a reasonable relationship to the actual injury that would be suffered if the other party failed to honor a term of the agreement. Given the holdings in *Gormley* and *Constellation-F*, parties should also be conscientious about including in settlement agreements representations concerning equal bargaining power and consideration of other alternatives.

Although the primary consideration for courts reviewing liquidated-damages provisions will continue to be whether they bear some reasonable relationship to actual damages, courts may now be more likely to review the totality of the circumstances under which that provision was negotiated. If counsel has been actively involved in negotiation of the liquidated-damages provision, the

agreement has a greater likelihood of being found enforceable.

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. ☒