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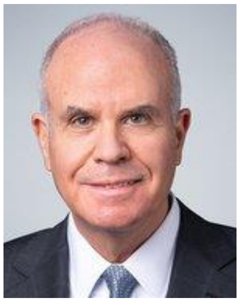
Errors To Avoid When Drafting Stipulated Judgments In Calif.

By **Mark Loeterman and Suzanne Segal** (August 21, 2020, 5:59 PM EDT)



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The coronavirus has created an array of financial challenges for businesses and individuals alike. More and more, in commercial dispute mediations, settling defendants are negotiating an extended time and flexible terms for payment. These terms are typically documented in a settlement agreement and stipulated judgment.

A common mistake in drafting the settlement agreement is that the financial terms inadvertently include an unenforceable penalty under Civil Code Section 1671, Subdivision (b), which governs liquidated damages. Liquidated damages are a predetermined sum that a contracting party agrees to pay for a breach.

Generally, a liquidated damages provision is valid unless its terms were unreasonable under the existing circumstances when the contract was made.[1] An unenforceable liquidated damages clause is one that requires payment that exceeds any possible judgment the plaintiff could have obtained.

Usually, the stipulation is coupled with a provision that allows the trial court to enter judgment in accordance with the settlement, and to retain jurisdiction. However, a court cannot enter a judgment that contains an unenforceable liquidated damages clause, as such provisions are void as against public policy.[2]

The Graylee v. Castro Decision

Background

The California Court of Appeal's Fourth Appellate District's recent decision in Graylee v. Castro,[3] a routine landlord-tenant dispute, illustrates the problem. The landlord brought an unlawful detainer action, alleging that tenants owed $27,100 in unpaid rent.

On the day of trial, the parties entered into a stipulated judgment which specified that the tenants were to vacate the property a month later. If the tenants complied, the landlord would waive the entire money judgment for unpaid rent, damages, attorney fees and costs. However, if the tenants failed to vacate, then the $28,970 money judgment would be fully collectible.

Subsequently, the landlord moved for entry of judgment because the tenants did not timely leave. After a hearing, the trial court found the tenants had not vacated and granted the landlord's motion.

On appeal, the tenants argued that the $28,970 judgment did not bear a reasonable relationship to the range of actual damages anticipated from a breach of the stipulation. The Fourth District agreed, directing the trial court on remand to consider whether the tenants had substantially complied with the stipulation and whether the landlord had suffered any actual damages.

Liquidated Damages

While the stipulation in Graylee did not use the phrase "liquidated damages," the legal effect of the stipulation was the same. It predetermined the amount of damages the landlord would be entitled to receive if the tenants breached.

The court explained that in the context of a stipulated judgment, it is the damages that flow from a breach of the stipulation, not a breach of the underlying contract, that is the key to enforceability:

> The amount of the judgment must reasonably relate to the damages likely to arise from the breach of the stipulation, not the alleged breach of the underlying contract, because it is the breach of the stipulation that allows [plaintiff] to enter judgment against the [defendant]." (citation omitted) Thus, we analyze the damages flowing from the breach of the stipulation itself, not any damages that may have arisen from the tenants' alleged breach of the underlying lease agreement.[4]

The Greentree, Vitatech and Jade Fashion Cases

The Graylee court's analysis rested on several decisions. Taken together, they provide valuable guidance to practitioners who contemplate using a stipulated judgment to secure payment of a settlement.

In Greentree Financial Group Inc. v. Execute Sports Inc.,[5] the parties settled a $45,000 contractual dispute and agreed to pay $20,000 in two installments. The stipulation provided that if the defendant missed either payment, the plaintiff was entitled to a $45,000 judgment, plus attorney fees and costs. After defaulting on the first payment, the court entered a $61,000 judgment.

The Fourth District found the judgment included an unenforceable penalty. Instead of attempting to anticipate damages flowing from a breach of the stipulation, the parties simply selected the amount the plaintiff claimed as damages in the underlying lawsuit, plus interest, attorney fees and costs.

In Vitatech International Inc. v. Sporn,[6] the plaintiff sued to recover $166,000 on a contract. On the eve of trial, the parties settled for a one-time payment of $75,000. As part of the settlement, the defendants stipulated to entry of judgment against them "in the full prayer of the Complaint," but the plaintiff agreed to forbear filing the stipulation and to accept $75,000 "as full Settlement" if the defendants paid by the designated date. When the defendants failed to pay,the trial court entered judgment for more than $300,000.

Relying on Greentree, the court found the stipulated judgment, which was more than four times the amount the plaintiff had agreed to accept as full settlement, contained an unenforceable penalty. It bore no reasonable relationship to the range of damages the parties could have anticipated would result from a default. "The characteristic feature of a penalty is its lack of proportional relation to the damages which may actually flow from failure to perform under a contract."[7]

The holding by the California Court of Appeal's Second Appellate District in Jade Fashion & Co. Inc. v. Harkham Industries Inc.[8] is particularly instructive and stands in sharp contrast to the Greentree and Vitatech cases. In Jade Fashion, the defendant purchased garments from the plaintiff and then fell behind on its payments. Prior to litigation, the parties settled, and the defendant expressly admitted to owing the plaintiff more than $341,000.

Under the settlement agreement, the defendant agreed to pay weekly installments until the balance was paid in full. If all payments were timely made, the defendant would receive a $17,500 discount on the total amount.

The defendant eventually made all its payments, though several were late. Despite this, the defendant deducted the discount from its final payment. The plaintiff demanded the outstanding $17,500, but the defendant refused to pay. The plaintiff sued for breach.

The appellate court held that the $17,500 discount was neither liquidated damages for a breach, nor was it an additional payment above any debt that was owed. Instead, the $17,500 was part of the $341,000 obligation, which the defendant admitted to owing. Thus, the Civil Code Section 1671 restrictions did not apply.

Because the defendant expressly agreed to pay the entire balance and take the $17,500 discount only if it paid each installment when due, the plaintiff suffered actual damages when the defendant tendered late payments, yet still took the discount.

Incentivizing Prompt Payment

How can a lawyer whose client agrees to a structured settlement avoid these issues? Structure the deal for an amount not greater than any potential judgment, with a discount if payment is early.

In Mitsuwa Corp. v. Wehba,[9] the Second District upheld a settlement agreement stipulating that the defendant-borrower owed $15 million, but also providing that if payment on the first $10.5 million was made on a timely basis, the remaining $4.5 million would be forgiven.

> Like the $17,500 at issue in Jade Fashion, the $4.5 million is simply a discount from the total obligation defendants owed Mitsuwa that was intended to incentivize them to make timely and complete payments under the Agreement. In other words, the $4.5 million has always been part of the $15 million defendants expressly admitted they owed and agreed to pay Mitsuwa to settle their dispute. As such, the provision of the Agreement requiring defendants to pay the full $15 million is neither a liquidated damages clause nor a penalty.[10]

Unlike the breaching parties in Greentree and Vitatech, the defendants in Mitsuwa did not settle for an amount that was disproportionately lower than the amount the plaintiff could recover for a breach of the agreement. Rather, the defendants agreed to pay the plaintiff the same amount of money ($15 million) that the plaintiff would be entitled to recover if the defendants breached.

Three days after the Mitsuwa Corp. decision issued, a different panel endorsed the idea of parties agreeing in a stipulated judgment to a discount for timely payment of an admitted debt. This case was Red & White Distribution LLC v. Osteroid Enterprises LLC, where the Second District held:

> Based on Jade Fashion, if the parties stipulate that the debt is a certain number, they may agree that it may be discharged for that number minus some amount. They may also agree that in the

> event the debtor does not timely make the agreed payments, a stipulated judgment may be entered for the full amount.[11]

In Red & White Distribution, Judge Brian Currey noted: "We publish to remind practitioners whose clients settle a dispute involving payments over time how to incentivize prompt payment properly, and what may happen if done incorrectly."[12] Clearly, courts have recognized that this is an area where parties frequently run afoul of the unenforceable penalty rule.

Drafting Tips for Stipulated Judgments

The lessons are straightforward.

Practitioners have a choice in how a stipulated judgment is structured. A discount for early payment is preferable to a surcharge for late payment.

The restrictions on liquidated damages clauses under Civil Code 1671(b) can be avoided when a defendant acknowledges in the settlement documents that the amount to be paid reflects an actual debt, as distinct from a compromise of disputed claims.

If there is going to be a surcharge, make sure it is proportional to the damages resulting from the payment default. In most instances, a surcharge that is not limited to a reasonable estimation of interest for loss of use, attorney fees and costs of collection, is at risk of being deemed an unenforceable penalty. Damages arising from the breach of the underlying contract are not relevant.

Creating a discount for early payment incentivizes both sides in a dispute, by giving greater confidence to plaintiffs that payments will be made and by providing a lower cost of settlement to defendants. Undoubtedly, during these difficult COVID-19 times, parties facing economic hardships are looking for creative settlement solutions. Stipulated judgments with terms that properly incentivize both sides may be one of those solutions.

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[1] Civil Code section 1671(b)

[2] Vitatech Internat., Inc. v. Sporn (2017) 16 Cal.App.5th 796, 807-808

[3] Graylee v. Castro, 2020 WL 4463186 (August 4, 2020)

[4] Graylee, supra.

[5] Greentree Financial Group, Inc. v. Execute Sports, Inc. (2008) 163 Cal.App.4th 495

[6] Vitatech Internat., Inc. v. Sporn (2017) 16 Cal.App.5th 769

[7] Vitatech at p. 699

[8] Jade Fashion & Co., Inc. v. Harkham Industries, Inc. (2014) 229 Cal.App.4th 635

[9] Mitsuwa Corp. v. Wehba, 2019 WL 3561928

[10] Mitsuwa Corp., supra.

[11] Red & White Distribution, LLC v. Osteroid Enterprises, LLC (2019) 38 Cal.App.5th 582, 589.

[12] Id. at p. 584.