On Appeals: Beware the Traps for the Unwary in Settlement Agreements

'Osteroid' provides several lessons to counsel whose clients settle a dispute for payments over time how to properly incentivize timely payments, and what may happen if it is done incorrectly.

By Kelly Woodruff | August 21, 2019 at 12:52 PM

It is not often a Court of Appeal will publish an opinion for the express purpose of reminding attorneys how to do their job properly. But the Second District's opinion in Red & White Distribution v. Osteroid Enterprises earlier this month did just that. Osteroid provides several lessons to counsel whose clients settle a dispute for payments over time how to properly incentivize timely payments, and what may happen if it is done incorrectly.

Osteroid loaned Red & White Distribution (R&W) $1.8 million. After Osteroid declared R&W had defaulted on the loan, R&W filed a complaint alleging the loan was usurious and unenforceable. Osteroid countered with a complaint alleging breach of contract and sought damages of $1.8 million plus interest and attorney fees. The parties settled all claims in exchange for payment from R&W to Osteroid of $2.1 million in installments over 13 months.

The parties also executed a stipulation for entry of judgment that was not to be filed unless R&W defaulted on the payment plan and failed to cure the default. The stipulated judgment provided that R&W was liable to Osteroid for $2.8 million, plus interest from the date of execution of the settlement, plus attorney fees. The parties' settlement provided that, in the event R&W defaulted on the settlement payment plan, Osteroid could file the stipulated judgment by ex parte application.
R&W defaulted, and Osteroid filed an ex parte application to enforce the stipulated judgment under Code of Civil Procedure §664.6. After providing R&W an opportunity to respond, the court granted the application and entered judgment for $2.8 million plus interest and attorney fees, resulting in a judgment of approximately $3.6 million.

R&W appealed, arguing that the $700,000 increase from the amount of the settlement ($2.1 million) to the stipulated judgment ($2.8 million) was not an enforceable liquidated damages provision, but instead constituted an unenforceable penalty under Code of Civil Procedure §1671, subdivision (b). The Court of Appeal agreed and reversed, holding that whether a liquidated damages provision is an unenforceable penalty is a question of law, and that the $700,000 increase bore “no reasonable relationship to the range of actual damages the parties could have anticipated from a breach of the agreement.”

The court went on to explain to attorneys how to structure a settlement agreement that requires payment in installments to avoid creating unenforceable penalty provisions. The court explained that to ensure enforcement of a liquidated damages clause that may be considered a penalty, parties should state in the settlement agreement that the actual debt is the higher number, but as a compromise of claims and in recognition of the timely payment of each installment, the plaintiff agrees to accept a lower total payment. The agreement should also expressly state that, in the event of default on the payment plan, a stipulated judgment may be entered for the full amount. This contractual language should transform an unlawful post-breach penalty into an uncontestable pre-breach discount.

The court went on to explain that if Osteroid had only included a statement in the settlement agreement that the agreed-upon amount of R&W’s debt was $2.8 million and the lower settlement amount was in consideration for timely payment, the $700,000 difference would have been enforceable along with interest on the full amount.

While Osteroid involved settlement agreements involving penalty-type clauses in the event of breach, the case highlights a number of tips for attorneys crafting settlement agreements.

One tip is that attorneys should not underestimate the value of factual recitals. In that often-overlooked portion of an agreement, any facts stated in the recitals are conclusively presumed to be true as between the parties to the agreement under Evidence Code §622. Thus, if the full amount of the debt owed is stated in a factual recital, the debtor cannot introduce any evidence that the debt is something less.
Another tip is that Osteroid was only able to enforce the settlement and have the court enter judgment under Code of Civil Procedure §664.6 (which provides that parties in pending litigation may request that the trial court retain jurisdiction to enforce the settlement agreement) because he expressly asked the court to retain jurisdiction. The statute requires that the parties formally ask the trial court to retain jurisdiction while still within “pending litigation,” which means the formal request must be made before dismissing the case.

Finally, while a stipulated judgment ordinarily cannot be appealed, R&W was able to appeal the trial court’s order enforcing the settlement agreement under CCP §664.6. The settlement agreement allowed Osteroid to apply to the court ex parte to enter the stipulated judgment, requiring Osteroid to file a motion to enforce the settlement agreement. When the court granted that request, and entered judgment as agreed, it was the order enforcing the settlement agreement that R&W appealed. Had the agreement allowed Osteroid to simply file the stipulated judgment after failure to cure a default, R&W would not have had a right to appeal.

Given the number of cases that settle each year, every litigator should know about the traps that can arise in settlement agreements—especially since the Court of Appeal just went to great lengths to remind them.