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PERSPECTIVE

## Discounts for timely payments: unenforceable 'penalties'?

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It has long been a practice among commercial litigators and their clients to agree to a settlement with a defendant/borrower which allows a discount if settlement payments are timely made. Unfortunately, this practice potentially has been invalidated by *Greentree Financial Group Inc. v. Execute Sports Inc.*, 163 Cal. App. 4th 495 (2008), and *Purcell v. Schweitzer*, 224 Cal. App. 4th 969 (2014).

Enter *Jade Fashion & Co. Inc. v. Harkham Industries Inc.*, 2014 DJDAR 12424 (Sept. 8, 2014). At first blush, it appears that, in circumstances similar to those in *Greentree* and *Purcell*, a court found offering such a discount was not an unenforceable "penalty" or forfeiture. However, a close reading shows no clear differences in the cases.

In *Jade*, Harkham Industries fell behind in its payments for goods supplied by Jade Fashion Inc. Jade subsequently negotiated an agreement with Harkham that provided for Harkham making certain weekly payments. In the event all such payments were timely, Jade agreed that Harkham could "discount" its final payment by \$17,500. Further, after the first two payments were timely paid, Jade agreed to release goods it was holding to Harkham. The agreement included a provision that "time is of the essence" in addition to providing that the payments must be made "when due" and that the parties also agreed the amount claimed by Jade was the full amount actually owed by Harkham.

Of course, the inevitable happened and several of Harkham payments were late by anywhere from three to 12 days. When the time came to make the final payment, Harkham paid two weeks early and deducted the \$17,500 — despite having been told repeatedly by Jade's counsel that they were in default and the discount was no longer available. Jade demanded the additional \$17,500. When that was not paid, Jade initiated the lawsuit and also asserted a claim for interest and attorney fees as part of its damages.

The court granted Jade's motion for summary judgment and Harkham appealed, pointing to *Greentree* and *Purcell*. The 2nd District Court of Appeal upheld the judgment, finding that the circumstances in *Jade* were distinguishable.

Under Civil Code Section 1671, liquidated damages are enforceable unless the party seeking to invalidate the provision shows that the provision was unreasonable

under the circumstances existing at the time it was made. Courts have held that liquidated damages must bear some reasonable relationship to the range of actual damages that the parties could have anticipated would result from a breach.

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The *Greentree* court found that a stipulated and entered judgment that was approximately \$40,000 more than the agreed-upon settlement amount "does not merely compensate the plaintiff — it rewards the plaintiff by penalizing the defendant," and held that it was therefore not reasonably related to the amount of damages the plaintiff could have been thought to incur by the parties at the time they entered into the settlement. Likewise, the *Purcell* court found a penalty unenforceable when the plaintiff sought judgment in the entire amount sought in the complaint (\$85,000 instead of the agreed upon settlement amount of \$38,000) and followed *Greentree*. The court further held that Section 1671 could not be circumvented by the plaintiff's attempted wording in the settlement that allegedly tied the greater amount of judgment to the costs of proceeding with post-judgment enforcement.

In *Jade*, the court found arguably similar facts to be a valid and enforceable agreement. There was a significant point made that the *Greentree* and *Purcell* cases involved settlements that occurred after the lawsuit was filed, and here the agreement was reached in forbearance of filing a lawsuit.

But perhaps more importantly, in *Jade* both parties agreed to the exact amount of the undisputed debt and that Harkham owed Jade that specific sum for goods sold and delivered. Thus, the court held, the "discount" of \$17,500 was not a penalty, but rather an actual part of the total amount owed. Therefore, the "reasonable relationship" test did not apply. The court further held that there was no agreement to compromise and instead, there was merely a discount which only could be taken upon the full performance by Harkham.

Harkham also unsuccessfully argued that the mere "label" of discount did not trans-

mute what was really an unenforceable penalty. The court dispensed with that citing to the plain language of the agreement stating that it did not support the finding that Jade "intended to penalize Harkham by agreeing to forbear on collection of a debt that was indisputably due and owing so long as timely payments on the original debt were being paid." The court similarly dismissed the argument that the loss of the discount constituted a forfeiture.

So are creditors' attorneys "safe" in drafting agreements that provide for a discount so long as payments are made as agreed, or do *Greentree* and *Purcell* still have validity? All three agreements were based on what can be characterized as the "carrot and stick" approach to settlement: If the defendant/debtor makes the payments as agreed, then they are rewarded with the "carrot" of the discount; if they do not make the payments, they get the "stick" of a larger judgment.

Are such agreements now enforceable, despite *Greentree* and *Purcell*? This is not so clear. Courts often follow their own district rule when there is a split of authority. Consider the following queries:

The *Jade* court distinguished itself from *Greentree* and *Purcell* based on the fact that the agreement in *Jade* was a pre-litigation workout. Does that make sense? Does that really matter as to the essence or enforceability of the agreement?

Should it matter if the case is resolved via a workout/forbearance agreement or a settlement agreement?

Should a workout agreement or settlement be deemed to include a penalty depending on whether or not it includes a stipulation for entry of judgment?

Should enforceability of the payment agreements be treated differently depending on whether or not it says it is a "settlement" or "compromise," rather than a "forbearance"?

Does it matter whether the higher default amount is "reasonably related" to the breach of the settlement agreement, or can it simply be the amount originally claimed due?

Does it matter whether the differential in the amounts is relatively small?

Do the specific buzzwords in the agreement really make a difference as to its enforceability?

Under the current circumstances, perhaps the best approach is to try to construct an agreement that follows the terminology of *Jade* as much as possible:

- Have the defendant agree to the total

amount owing and that it is actually due and owing and not disputed;

- Have the defendant acknowledge that the amount was owed in exchange for goods or services, or a loan;

- Have the defendant acknowledge and agree that the lower amount is an inducement for prompt and earlier payment, and not a compromise or novation of the actual amount owed

- Have the defendant acknowledge and agree that the higher amount is not a liquidated damage, penalty or otherwise unenforceable;

- Don't use the word "compromise" or settlement, but use "forbear" where possible;

- Make it as clear as possible in the settlement that any deviation from the agreed forbearance conditions by the defendant will result not in a penalty or forfeiture, but rather in the cessation of forbearance and the enforcement of the defendant's agreement to pay the amount actually due. (Include standard terms of future non-waiver by failure to act on any particular event of untimely payment.)

- Don't forget to include attorney fees to be shown by declaration at entry of judgment and thereafter via memo of costs (This did not happen in *Greentree*.)

And, don't forget to advise your client of the risks of litigation expense and result, despite your adherence to the language in *Jade*. We just don't know yet how this is going to turn out. Stay tuned.

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