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Assessing When a Discounted Payoff Agreement Becomes an Unenforceable Penalty

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California courts have long wrestled with the enforceability of contracts executed after a prior problem between the parties, under which one party will pay money, but must pay a higher amount if they fail to make certain future payments on time. Is the higher payment amount a valid liquidated damages provision, an unenforceable penalty, or something else? Under California law, a liquidated damages provision, in which the parties agree in advance to a specific damage amount in the event of default, is valid if the amount bears a reasonable relationship to the actual damages the parties could have anticipated at the time the contract was executed, but if the selected amount is disproportionate to such anticipated damages, it is an unenforceable penalty. Conversely, if the provision is not a liquidated damages provision at all, but instead represents a potential discount of an admitted debt that becomes effective only if timely payments are made, the liquidated damages analysis does not apply and the provision is enforceable.

In *Vitatech International, Inc. v. Sporn*, California's Fourth District Court of Appeal recently clarified the factors courts will consider in determining the enforceability of contracts with these provisions, which frequently arise in the context of dispute resolution. The *Vitatech* case involved a breach of contract lawsuit that settled on the eve of trial, with the defendant agreeing to pay Vitatech $75,000 and executing a stipulation for entry of judgment against them for the full amount Vitatech sought in the action (~ $300,000) if the defendant failed to timely pay the $75,000. In assessing whether the liquidated damages or the discount analysis applied to the stipulation for entry of judgment, the *Vitatech* court noted that the stipulation resolved disputed claims in pending litigation, that the defendant never admitted liability on the underlying claims, and that the defendant never admitted the amount of damages caused by the underlying breach. Since there was no admitted liability for a specific debt, the court ruled the stipulation could not be deemed a discount. Turning to the liquidated damages analysis, the court determined that the $300,000 judgment did not bear a "reasonable relationship" to anticipated damages Vitatech might suffer from the failure to receive $75,000, and that it was an unenforceable penalty.

POTENTIAL IMPACT

Lenders negotiating discounted payoffs or modifications that call for reinstatement of full loan balances in the event future payments are not timely should be careful to include the borrower's admissions of liability in the full amount, and should avoid language suggesting the new agreement is a compromise of disputed claims.