

Management Alert



New California Supreme Court Decision Will Make it More Difficult to Enforce Integrated Written Contracts

A recent decision by the California Supreme Court will make it more difficult for parties to enforce integrated written contracts where allegations of fraud exist. In *Riverisland Cold Storage v. Fresno-Madera Production Credit Ass'n*, (No. S190581, January 14, 2013), the Court held that the parol evidence rule, which generally precludes parties from introducing extrinsic evidence to contest the validity of an integrated written contract, does not prevent a party from using oral statements made before entry into the contract, which contradict the written terms of the agreement, to show that the contract was obtained through fraud. This opinion overrules the Court's 1935 decision in *Bank of America etc. Ass'n. v. Pendergrass* (1935) 4 Cal.2d 258, which held that under the parol evidence rule, a contracting party could not introduce evidence of prior oral statements at variance with the terms of a written contract to prove that the contract was obtained through fraud. This decision has significant implications for those seeking to enforce written contracts in California.

The Parol Evidence Rule

The parol evidence rule codified in Code of Civil Procedure section 1856 and Civil Code section 1625 provides that the terms of a writing the parties intend to be final expression of their agreement as to the terms included in that writing (otherwise known as an integrated agreement), may not be contradicted by evidence of a prior agreement (written or oral) or of a contemporaneous oral agreement. The rule is subject to a number of exceptions. For example, California permits the introduction of evidence relevant to the issue of the underlying validity of the written contract itself in Code of Civil Procedure section 1856(f). Evidence to establish illegality or fraud is also not excluded by the parol evidence rule.

The *Pendergrass* Decision

In *Pendergrass*, after borrowers fell behind on loan payments, they entered into a new promissory note with lender. Under the terms of that new written agreement, borrowers provided additional collateral and the bank had the ability to demand payment of the note at any time. After the note was executed, the bank then seized borrowers' collateral and brought suit to collect on the note. In response, borrowers claimed before they entered into the new note, the bank orally promised not to disturb their farming operations during the rest of the year, and to accept the proceeds from those operations in payment for that year. Borrowers argued that the bank's contradictory oral statements were made to fraudulently induce borrowers to enter into the new note and put up the additional collateral.

The *Pendergrass* Court rejected borrowers' contention that evidence of the prior contradictory statements should be admitted to prove promissory fraud by the bank in the making of the new contract. The Court held that the parol evidence rule barred the admission of such evidence because the prior oral statements directly contradicted the terms of the written agreement. The Court reasoned that allowing such easily falsified oral testimony to be admitted as evidence would risk having the party seeking to enforce the written agreement found guilty of fraud every time. The ruling by the *Pendergrass* Court narrowly limited the fraud exception of the parol evidence rule to those instances where evidence of fraud could be established by "some independent fact or representation, some fraud in the procurement of the instrument or some breach of confidence concerning its use, and not a promise directly at variance with the promise of the writing." See *id.* at 263.

The *Riverisland* Decision

The facts in *Riverisland* are very similar to those in *Pendergrass*. *Riverisland* involved borrowers who fell behind in their loan payments. They then entered into a written debt restructuring agreement with lender providing, among other things, that lender would take no enforcement action against borrowers for approximately three months if borrowers made specified payments. In addition, pursuant to the terms of the restructuring agreement, borrowers pledged eight separate parcels of real property as additional collateral.

When borrowers did not make the required payments, the lender recorded a notice of default and initiated foreclosure proceedings. Thereafter, borrowers repaid the loan and the foreclosure proceedings were dismissed by lender. Borrowers then sued lender seeking damages for fraud and negligent misrepresentation. Borrowers claimed that lender's vice president met with them two weeks before the agreement was signed, and told them that lender would extend the loan for two years in exchange for additional collateral consisting of two ranches only. Borrowers further claimed that when they signed the agreement, the vice president reiterated that the term was two years and the two ranches were the only additional security, contrary to the terms of the written agreement, which contained only a three month forbearance and identified eight parcels as additional collateral. Borrowers conceded during the litigation that they signed the agreement without reading it.

Relying on the decision in *Pendergrass*, the trial court granted summary judgment in favor of the lender, holding that the fraud exception does not allow the admission of parol evidence of promises "at odds with the terms of the written agreement." The Court of Appeal reversed, ruling that *Pendergrass* is limited to cases of promissory fraud and the vice president's alleged promises were factual oral misrepresentations beyond the scope of the *Pendergrass* rule.

The California Supreme Court upheld the ultimate result of the Court of Appeal, holding that the parol evidence rule does not exclude evidence of prior oral statements that contradict the terms of a written agreement, in order to establish fraud. In doing so, the Court expressly overruled its prior decision in *Pendergrass* and its progeny, finding *Pendergrass* to be an aberration, which was poorly reasoned and contrary to statutory and case authority, as well as public policy. The Court reasoned as follows:

- 1. Statutory** - Code of Civil Procedure section 1856, first enacted in 1872, broadly permits the introduction of evidence relevant to the validity of an agreement and exempts evidence of fraud from the proscription of the parol evidence rule;
- 2. Case Law** - California Supreme Court decisions prior to *Pendergrass* placed no limitation on the admission of parol evidence to prove fraud in the making of a contract; and
- 3. Policy** - Excluding evidence of prior statements at variance with the terms of a written agreement has the potential to facilitate and encourage fraud, allowing a the parol evidence rule to be used to "shield fraudulent conduct."

Observing that *Pendergrass* failed to account for the fundamental principle that fraud undermines the essential validity of the parties' agreement, the Court reached back to its opinion in *Ferguson v. Koch* (1928) 204 Cal. 342, 347, noting, "[p]arol evidence is always admissible to prove fraud, and it was never intended that the parol evidence rule should be used as a shield to prevent the proof of fraud."

What *Riverisland* Means for Parties Contracting in California

The Court's decision in *Riverisland* has several significant ramifications for parties contracting in California:

1. Fraud is Likely to be Raised More Frequently to Challenge the Validity/ Enforceability of Written Contracts in California.

As a result of the decision in *Riverisland*, it is likely that more parties will attempt to challenge the validity/enforceability of a written contract under a fraud theory, based upon alleged oral representations made by another party to the contract at variance with the terms of the written contract. While *Pendergrass* did not completely pre-empt parties from asserting claims

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for fraudulent inducement in connection with the making of a contract, the Court's decision in *Riverisland* broadly expands the evidence a party may introduce to support invalidating a contract based upon fraud. However, this does not mean that parties challenging the validity/enforceability of a contract on grounds of fraud will necessarily prevail at the end of the day. The *Riverisland* Court emphasized that such a party must still prove all the elements of fraud, including intent to deceive and reliance on the fraudulent promise. In fact, the Court indicated that a borrower's justifiable reliance on a claim for fraud in the execution might be negated by an admission that the party did not read the agreement when he or she signed it.

2. Obtaining Summary Judgment on Claims for Breach of Contract is Likely to Be More Difficult.

Because courts must now consider evidence of prior oral statements that contradict the express terms of a written agreement where a fraud claim is asserted, judges may be more reticent to grant summary judgment on claims for breach of contract, where the enforceability of the contract is challenged on the basis of fraud. Under such circumstances, the introduction of a fraud element into the analysis as to whether a valid contract exists, has the potential to converting what might otherwise be a question of law into a question of fact, potentially reducing the likelihood that the party seeking to enforce the contract will be able to do so by means of summary judgment.

3. Contracting Parties Should Consider Making Material Contractual Provisions Especially Conspicuous.

While this constitutes good practice in general, contracting parties, more so than ever, should consider highlighting and accenting a contract's material terms with bold, capital letters, or larger font size, to support a defense against any later allegations of fraud. Contracting parties should also consider requiring initials on key contractual terms, including the contract's integration clause. Contracting parties should also consider including a clause that the parties have had the opportunity to consult independent counsel and freely and knowingly enter the contract and understand its terms. These steps may help to undermine later arguments that a party did not know that the terms of the written contract were different from prior, contradictory oral representations, or that reliance on any such oral representations was substantially justified.

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