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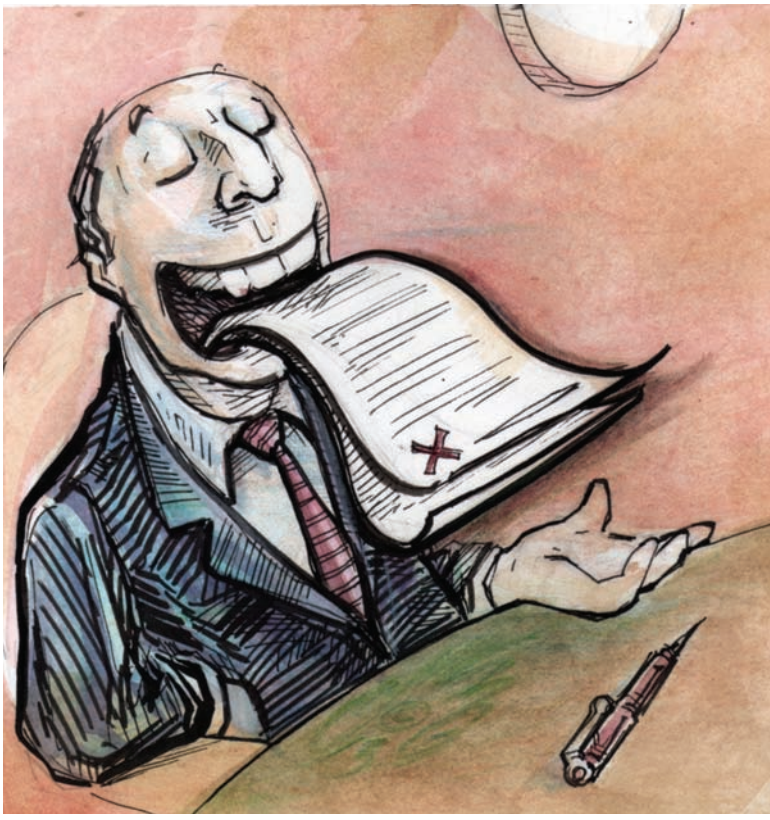
The Fraud Exception to the Parol Evidence Rule after *Riverisland*

THE PAROL EVIDENCE RULE, subject to certain exceptions, limits the interpretation of a contract to its "four corners" and excludes such extrinsic evidence as oral statements that conflict with the terms of the signed writing. The parol evidence rule and its exceptions are codified in California in Code of Civil Procedure section 1856. One well-established exception is fraud in the inducement of the agreement, but in 1935 the California Supreme Court, in *Bank of America v. Pendergrass*,[1] held that the alleged false promise was inadmissible if it was directly at variance with what was in the written contract. Since then, with regard to allegations of false promises, parties to written contracts have been able to rely on the signed agreement as a defense. However, earlier this year the supreme court reversed course and retired the *Pendergrass* rule.

The court's decision in *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association*[2] overruled this long-standing principle of law and may not only increase and prolong litigation but also may reshape the procedures for entering into valid and enforceable written agreements. By overruling *Pendergrass,* the supreme court opened the door to challenges of written contracts with evidence of oral statements that conflict with the promises of performance set forth in the executed agreements. The significance of *Riverisland* is corroborated by the subsequent court of appeal decision in *Julius Castle Restaurant, Inc. v. James Frederick Payne*,[3] which gave *Riverisland* an expansive interpretation. From a transactional standpoint, henceforth, parties that enter into sophisticated contractual arrangements need to exercise greater caution in executing agreements. From a litigation standpoint, *Riverisland* and its progeny will tend to make it harder to dispose of fraud claims on the pleadings. The two cases do explicitly leave the door open to pretrial challenges to a plaintiff's justifiable reliance on promises that are at odds with those stated in the written contract, but it is nonetheless hard to underestimate the possible impact the two cases will have on the formation and enforcement of contracts in California.

The Parol Evidence Rule

The parol evidence rule prohibits the introduction of any extrinsic evidence to alter, vary, or add to the terms of a written agreement.[4] Under the rule, the terms of a writing intended by the parties as a final and integrated expression of their agreement cannot be contradicted by extrinsic evidence, including prior oral statements or contemporaneous oral agreements.[5] The rule is a longstanding, well-known principle that promotes fairness and predictability by encouraging parties to specify the entirety of their agreements in writing.[6] As the court in *Riverisland* stated, "[W]hen the parties put all the terms of their agreement in writing, the writing becomes the agreement, and the written terms supersede statements made during negotiations."[7] The parol evidence rule "is based on the assumption that written evidence is more accurate than human memory and the fear that fraud or unintentional invention by witnesses interested in the outcome of the litigation will mislead the finder of facts."[8] Moreover, by limiting a dispute to the applicable written agreement, California courts benefit from reduced



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litigation. As the supreme court has noted, the parol evidence rule also protects the integrity of written contracts by making their terms the exclusive evidence of the parties' agreement.[9]

Nevertheless, the parol evidence rule does not always exclude extrinsic evidence, including oral agreements. Specifically, Code of Civil Procedure Section 1856(f) states that "where the validity of the agreement is the fact in dispute, this section does not exclude evidence relevant to that issue."[10] As the *Riverisland* court noted, "This provision rests on the principle that the parol evidence rule, intended to protect the *terms* of a valid written contract, should not bar evidence challenging the *validity* of the agreement itself."[11] The court added, "Evidence to prove that the instrument is void or voidable for mistake, fraud, duress, undue influence, illegality, alteration, lack of consideration, or another invalidating cause is admissible as such evidence. This evidence does not contradict the terms of an effective integration, because it shows that a purported instrument has no legal effect."[12] It is an established exception to the parol evidence rule that a party

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may present extrinsic evidence to show that the agreement was tainted by fraud.[13] However, despite this broad categorical exception, *Pendergrass* restricted for nearly 80 years the applicability of the fraud exception to cases of alleged promissory fraud—that is, cases in which the alleged misrepresentation is not of an existing fact but instead a promise to act (or refrain from acting) in a certain way in the future.

Pendergrass

The court in *Pendergrass* restricted the applicability of the fraud exception as a means to introduce extrinsic evidence by holding that "evidence offered to prove fraud must tend to establish 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."[14] Thus, according to the *Pendergrass* court, evidence of promissory fraud based on oral agreements that conflicted with the terms of the written agreement was not admissible under the fraud exception to the parol evidence rule. This restriction, while not directly overturned, was attacked and criticized by many California courts.[15] As the court in *Riverisland* noted, "The primary ground of attack on *Pendergrass* has been that it is inconsistent with the broad principle, reflected in Code of Civil Procedure Section 1856, that a contract may be invalidated by a showing of fraud."[16] Another court has observed that "One noted impact of the *Pendergrass* holding was that the parol evidence rule effectively immunized against liability for *both* prior and contemporaneous statements at variance with the written contract, and it implied that the alleged wrongdoer is innocent of fraud."[17] In overruling *Pendergrass*, the court in *Riverisland* abandoned this strict limitation.

Riverisland

In *Riverisland*, the plaintiffs defaulted under the terms of a loan obtained from defendant Fresno-Madera Production Credit Association (FMPCA).[18] The plaintiffs and FMPCA agreed to a forbearance agreement whereby FMPCA agreed that it would refrain from taking enforcement action for three months.[19] In exchange, the plaintiffs agreed to make payments and pledged eight separate parcels of real property as additional collateral. The plaintiffs initialed pages bearing the legal description of each piece of property that was being pledged; however, the plaintiffs did not read the agreement but simply signed it at the locations tabbed for signature. The plaintiffs alleged that they did not know that the document they were signing contained terms that differed from the terms that they had discussed with FMPCA's executives.[20]

The plaintiffs alleged that FMPCA's vice president met with them two weeks prior to the execution of the agreement and told them that FMPCA would extend the loan agreement for two years and that two pieces of property were all that was needed for collateral. Moreover, the plaintiffs alleged that these assurances were repeated at the execution of the forbearance agreement. Although the plaintiffs defaulted under the terms of the forbearance agreement, causing FMPCA to initiate foreclosure proceedings, they ultimately repaid the loan, and FMPCA dismissed the foreclosure action. Despite this resolution, the alleged misrepresentations of FMPCA's officer concerning the terms of the agreement were the basis for the plaintiffs' action for fraud and negligent misrepresentation.[21]

FMPCA moved for summary judgment, arguing that any evidence contrary to the terms of the written agreement was to be excluded pursuant to the parol evidence rule.[22] The trial court agreed and, citing *Pendergrass*, ruled that the fraud exception to the parol evidence rule does not allow parol evidence of promises that are at odds with the terms of the written agreement.[23] The court of appeal reversed, and the supreme court affirmed the reversal, referring to *Pendergrass* as an "aberration" and stating that such a restriction on the fraud exception was inconsistent with the statute and settled case law.[24]

The court noted that "although a written instrument may supersede prior negotiations and understandings leading up to it, fraud may always be shown to defeat the effect of an agreement."[25] In overturning *Pendergrass*, the *Riversland* court added that *Pendergrass* "failed to account for the fundamental principle that fraud undermines the essential validity of the parties' agreement."[26] The court continued, "When fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds."[27] In affirming the court of appeal's reversal of a summary judgment based on the exclusion of the oral statements by FMPCA's representatives, the court opined, "the parol evidence rule should not be used as a shield to prevent the proof of fraud."[28] Thus, it is now established law in California that, even in cases of promissory fraud, extrinsic evidence that differs from the terms of a written agreement may be admitted to support a cause of action for fraud.

Riverisland is a recent case that has not yet been widely cited by other courts. Nevertheless, in *Julius Castle Restaurant* the court of appeal affirmed a trial court's admission of parol evidence in connection with alleged fraud relating to a lease agreement, citing *Riverisland*.[29] Specifically, the court noted that *Riverisland* established that oral statements that conflicted with the lease terms were admissible under the statutory exception for fraud found in Section 1856(g).[30] The court in *Julius Castle Restaurant* looked back to the *Riverisland* decision and provided more direction for parties making contracts in a post-*Riverisland* world.[31]

The *Julius Castle Restaurant* court rejected claims by the defendants that *Riverisland* requires that the circumstances of each case and the bargaining power and sophistication of the parties to be considered in determining whether or not to admit extrinsic evidence concerning fraud.[32] In deciding not to limit the application of *Riverisland* by excluding sophisticated parties the court observed, "[O]ur high court sought the opposite result, namely, to create certainty and consistency by eliminating altogether the judicially created exception to section 1856, subdivision (g)."[33] The court similarly rejected the notion that *Riverisland* should only be applied to "contracts of adhesion where there is a disparity in bargaining power," stating that the *Riverisland* court "did not limit its holding to contracts of adhesion and we decline to read such a limitation into the decision." In short, the court was clear and adamant in declining "to carve out an exception to the *Riverisland* holding that the court itself did not endorse."[34]

While the court declined to carve out exceptions, it did provide some guidance to those seeking to dispose of claims that previously would have been subject to the *Pendergrass* rule. The key, the court indicated, lies in "addressing the heightened burden of proving fraud in a civil action" and, in particular, in focusing on the "justifiable reliance element of fraud." As the court stated, "Among the questions to ask are: What are the plausible reasons for the alleged discrepancy between the claimed oral promises and the signed writing? Is there compatibility between the oral representations and the written document? What is the evidence relating to whether the document was read and considered before signing?"[35] Since these questions generally implicate issues of fact, pretrial battles over promissory fraud claims that once would have been subject to *Pendergrass* will likely shift from pleadings to summary judgment.

After *Riverisland*

As a result of *Riverisland* and its progeny, companies that routinely enter into commercial contracts with their customers, vendors, clients, and strategic partners must be more careful than before. Precontractual negotiations, discussions, and other oral state-

ments are made in connection with all written agreements. The key to making deals after *Riverisland* is to ensure that the terms of the arrangement are documented in a written contract that is the complete integration of the agreement and that there is no need to introduce oral statements or other extrinsic evidence.

Practitioners with clients seeking to avoid fallout from *Riverisland* ought to advise them to take significant steps to avoid misunderstandings, confusion, and ambiguity regarding deal terms, thereby decreasing the risk that a court may undercut the enforceability of a written contract. To mitigate risk, it is recommended that attorneys and clients take the following precautionary measures: 1) develop a systematic process with respect to preparing written agreements to document and accurately reflect deal terms, 2) limit the number of company representatives that are responsible for explaining and discussing agreements with customers, 3) provide all parties with multiple opportunities for consultation with professional advisers and include written representations in the agreement to that effect, 4) provide the client or customer with execution versions of all written contracts well in advance of any scheduled signings, 5) avoid "take it or leave it" sales pressure tactics, 6) require that key contract provisions be initialed, 7) be sure that all contract agreement provisions clearly represent the terms of the deal, 8) include a clear and understandable discussion of an integration clause that puts the other party on notice that the written contract constitutes the final terms of the deal and that prior oral discussions that may conflict with the terms of the written document are not a part of the final agreement, 9) to the extent resources allow, have more than one employee present during all contract discussions and negotiations, and 10) strenuously advise that all parties read the written contract. These precautionary measures, if properly implemented, will provide clients with added reassurance that they can rely on the terms of their written agreements. ■

[1] Bank of Am.v. Pendergrass, 4 Cal. 2d 258 (1935).
[2] Riverisland Cold Storage, Inc. v. Fresno-Madera Prod. Credit Ass'n, 55 Cal. 4th 1169 (2013).
[3] Julius Castle Rest., Inc., et al. v. James Frederick Payne, et al., 216 Cal. App. 4th 1423 (2013).
[4] *Id.* at 1439 (citing Casa Herrera, Inc. v. Beydoun, 32 Cal. 4th 336, 343 (2004)).
[5] Julius Castle, 216 Cal. App. 4th at 1439 (citing Singh v. Southland Stone, U.S.A., Inc., 186 Cal. App. 4th 338, 352 (2010)).
[6] Julius Castle, 216 Cal. App. 4th at 1439.
[7] Riverisland, 55 Cal. 4th at 1174.
[8] Julius Castle, 216 Cal. App. 4th at 1439.
[9] Riverisland, 55 Cal. 4th at 1171-72.
[10] *See* CODE CIV. PROC. §1856(f).
[11] Riverisland, 55 Cal. 4th at 1174 (emphasis in original).
[12] *Id.* at 1174-75 (citing 2 WITKIN, CAL. EVIDENCE §97, DOCUMENTARY EVIDENCE 242 (5th ed. 2012)).
[13] Riverisland, 55 Cal. 4th at 1172; CODE CIV. PROC. §1856(g).
[14] Riverisland, 55 Cal. 4th at 1172 (citing Bank of Am.v. Pendergrass, 4 Cal. 2d 258, 263 (1935)).
[15] Riverisland, 55 Cal. 4th at 1172, 1176-77.
[16] *Id.* at 1176.
[17] Julius Castle, 216 Cal. App. 4th at 1440 (citing Casa Herrera, Inc. v. Beydoun, 32 Cal. 4th 336, 347 (2004)) (emphasis in original).
[18] Riverisland, 55 Cal. 4th at 1172.
[19] *Id.* at 1172-73.
[20] *Id.* at 1173.
[21] *Id.*
[22] *Id.*
[23] *Id.* (citing Bank of Am.v. Pendergrass, 4 Cal. 2d 258, 258 (1935)).
[24] Riverisland Cold Storage, Inc. v. Fresno-Madera Prod. Credit Ass'n, 55 Cal. 4th 1169, 1181-82 (2013).
[25] *Id.* at 1181 (citing Fleury v. Ramacciotti, 8 Cal. 2d 660, 662 (1937)).
[26] Riverisland, 55 Cal. 4th at 1182.
[27] *Id.*
[28] *Id.* at 1182 (citing Ferguson v. Koch, 204 Cal. 342, 347 (1928)).
[29] Julius Castle Rest., Inc., et al. v. James Frederick Payne, et al., 216 Cal. App. 4th 1423, 1439-40, 1441 (2013).
[30] *Id.* at 1439-40.
[31] *Id.* at 1441.
[32] *Id.*
[33] *Id.* at 1442.
[34] *Id.*
[35] *Id.*