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California Supreme Court Broadens the Fraud Exception to the Parol Evidence Rule

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On January 15, 2013, the California Supreme Court issued an opinion potentially expanding the nature of fraud claims challenging the validity of written contracts. In *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association,* the California Supreme Court overturned long-standing precedent that barred plaintiffs pursuing fraud claims from presenting evidence of representations defendants allegedly made if those representations directly conflicted with the terms of a written agreement between the parties.

The Parol Evidence Rule

The parol evidence rule is a well-established principle of common law codified in California Code of Civil Procedure section 1856 and Civil Code section 1625. The parol evidence rule generally prohibits the introduction of either oral or written extrinsic evidence to vary, alter or add to the terms of an integrated written agreement. The rationale behind the rule is that a written integrated contract establishes the terms of the agreement between the parties and evidence that contradicts the written terms is irrelevant to its interpretation, i.e., the integrated agreement constitutes the final expression of the terms of the agreement.

Like most rules, however, the parol evidence rule has its exceptions. For example, the parol evidence rule does not apply when the validity of the agreement itself is in dispute, or when the evidence is used to explain an ambiguity in the contract. Significantly here, the parol evidence rule also does not apply when the evidence is used to establish fraud by a party (the so-called "fraud exception").

The *Pendergrass* Opinion

In a 1935 case, *Bank of America etc. Assn. v. Pendergrass*, the California Supreme Court imposed a limitation on the fraud exception by holding the exception does not apply to evidence offered to show a promise directly contradicting the terms of a written agreement, and therefore such evidence was not admissible. Over the next 78 years, California courts struggled to apply the *Pendergrass* opinion, some reluctantly prohibiting plaintiffs from introducing parol evidence contradicting the terms of a written agreement with others interpreting the *Pendergrass* rule narrowly as possible to allow parol evidence. In *Riverisland*, the California Supreme Court reconsidered the *Pendergrass* holding.

The *Riverisland* Opinion

In *Riverisland,* the plaintiffs defaulted under a loan agreement with the defendant. The parties restructured the loan by entering into an agreement which, by its written terms, stated the defendant would take no enforcement action for three months and in return the plaintiffs would pledge eight parcels of property as new collateral. The plaintiffs later filed an action against the defendant for fraud and negligent misrepresentation, seeking rescission and reformation of the restructured agreement. The plaintiffs alleged that, contrary to the terms of the restructured agreement, the defendant had agreed to extend the loan for two years and required only two parcels of land to be pledged as additional collateral. The plaintiffs admitted they relied only on the defendant's oral statements to this effect and had not read the agreement. The defendant successfully moved for summary judgment under *Pendergrass*, arguing the plaintiffs could not present any evidence of representations contradicting the terms of the restructured agreement.

On appeal, the appellate court reversed the trial court's decision, holding the fraud exception to the parol evidence rule applied because *Pendergrass* was limited to cases of promissory fraud (i.e., fraud pertaining to misrepresentations made to induce the plaintiff to sign the agreement). The appellate court reasoned that because the fraud here pertained to the actual terms of the agreement, the alleged misrepresentations were outside the scope of the *Pendergrass* exception and the plaintiffs should have been allowed to introduce evidence of the defendant's alleged representations. The defendant petitioned the California Supreme Court for review.

On review, the court held that: first, *Pendergrass* was inconsistent with the principle that a contract may be invalidated by a showing of fraud and had the undesirable effect of furthering fraudulent practices; second, the distinction between promises that directly contradict written terms and those that do not at best is tenuous and difficult to apply, as evidenced by the inconsistent lower court opinions issued since *Pendergrass*; and third, when the California legislature amended the statutory rule for parol evidence in the 1970s, it purposefully ignored the *Pendergrass* holding and instead codified a broad fraud exception to the parol evidence rule without limitations to it. For these reasons, the court overturned *Pendergrass,* calling it an "ill-considered" decision, and held the fraud exception to the parol evidence rule now applies even when the alleged fraudulent statement directly contradicts the written terms of the agreement.

Possible Practical Effects of *Riverisland*

Riverisland has been suggested as being a groundbreaking opinion potentially undermining written agreements by allowing assertion of fraud claims based on the defendant's alleged representation of terms to the plaintiff different than those in the written agreement. Critics of the opinion have expressed concerns that *Riverisland* threatens the integrity of written agreements, noting the holding could be especially detrimental to large institutions routinely documenting standard agreements with consumers containing boilerplate terms by allowing these consumers to more easily threaten or assert fraud claims in an effort to be relieved of their contractual obligations.

Notwithstanding these implications, and the concerns cited by critics of the *Riverisland* case, the opinion is not the death knell to written agreements. Even in the wake of the *Riverisland* opinion, a plaintiff pursuing a fraud claim still must establish **justifiable reliance** on the alleged fraud or misrepresentation. In many cases, a plaintiff would have a difficult time establishing he or she justifiably relied on a representation contradicting the signed written agreement. Nonetheless, the opinion underscores the importance for an agreement to include an effective integration clause reflecting the parties' understanding that the written agreement constitutes the complete and final agreement between the parties, and that the parties did not rely on any representations made outside of its terms. Besides revisiting the substantive language in a contract's integration clause to give it greater weight, parties may wish to consider highlighting the integration clause in bold text and having it initialed, or requiring the parties to handwrite the integration clause when signing the agreement, thereby making it a more conspicuous provision and less likely for a plaintiff to successfully claim he justifiably relied on a representation made outside of the written terms of the agreement.

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