

Litigation Alert:

California Supreme Court Announces Sea-Change in Rules Governing Use of Parol Evidence to Show Fraud in Contract Interpretation

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Background

On January 14, 2013, the California Supreme Court issued a unanimous decision clarifying – and ultimately rewriting – the applicable legal standard for introduction of parol evidence to show that a contract is tainted by fraud. *Riverisland Cold Storage, Inc. v. Fresno-Madera Prod. Credit Ass'n*, S190581 (Jan. 14, 2013) (“*Riverisland*”). Since 1872, California’s parol evidence rule has prohibited introduction of oral testimony in contract interpretation, making the written terms the exclusive evidence of a parties’ agreement. See Cal. Code Civ. Proc. §1856; Cal. Civ. Code § 1625. Included in the statutory language, however, is a broad exception which allows a party to present extrinsic evidence to show that the agreement was tainted by fraud. Cal. Code Civ. Proc. §1856(f).

The *Pendergrass* Rule

In 1935, the Court adopted a limitation on this so-called fraud exception, since referred to as the *Pendergrass* Rule, requiring that any 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.” *Bank of America National Trust and Savings Ass’n. v. Pendergrass*, 4 Cal.2d 258, 263 (1935). In *Pendergrass*, an in-arrears borrower sought to present evidence of an alleged oral promise that directly contradicted the “payable on demand” term of the written agreement, a promissory note the bank was seeking to enforce. The Court excluded the evidence because, it reasoned, to do otherwise would allow easily falsified oral testimony to result in the party seeking to enforce a written agreement being found guilty of fraud far too easily. Thus, under the *Pendergrass* Rule, external evidence of promises inconsistent with the express terms of a written contract are not admissible, though evidence of promises not contradictory to the written terms might be.

Application of the *Pendergrass* Rule

Since the Court’s ruling in *Pendergrass*, California courts have adhered to the rule, albeit with varying degrees of compliance, and in some cases outright resistance. As noted by the Supreme Court in *Riverisland*, criticisms of *Pendergrass* include that the rule is at odds with the express language of California’s parol evidence statute, and its limitation on evidence of fraud may itself result in encouragement of fraudulent behavior. Additionally, many courts have struggled with the application of the *Pendergrass* Rule because the distinction between promises that are consistent with a given writing and those that are not, is often unclear, resulting in uncertainty in the case law.

The *Riverisland* Case

In *Riverisland*, like in *Pendergrass*, a borrower fell behind on a loan payment. The parties restructured their debt in a 2007 agreement that expressly provided three months of foreclosure forbearance and identified eight parcels of real property as additional collateral. The borrowers signed and initialed the agreement, though allegedly did not read it, and then failed to make their required payments as set forth in the agreement. After three months, the defendant lender recorded a notice of default. The borrowers eventually repaid their loan and avoided foreclosure, but filed suit for fraud and negligent misrepresentation alleging that they had met with a representative of the lender two weeks before the parties signed the new agreement who orally promised to extend the loan for two years in exchange for the additional collateral of two ranches. This alleged oral promise was directly at odds with the written terms of the signed agreement.

The trial court granted summary judgment to the defendant lender, applying the *Pendergrass* Rule to find that the fraud exception does not

allow admission of the borrowers' parol evidence of promises contradicting terms of the written agreement. The Court of Appeal reversed, following the reasoning of other cases limiting the application of *Pendergrass* to cases of promissory fraud. In contrast, the purportedly false statements the borrowers sought to introduce were directed at the *contents* of the agreement and therefore amounted to factual misrepresentations beyond the scope of the *Pendergrass* Rule.

***Pendergrass* Overruled**

In expressly overruling *Pendergrass*, the California Supreme Court determined that the *Pendergrass* Rule was both at odds with existing case law at the time the case was decided, as well as unsupported by the very law it relied on for its holding, thus concluding "...that *Pendergrass* was an aberration." *Riverisland* at 16. Not only was the *Pendergrass* Rule at odds with California case law at the time, the Supreme Court noted that the rule was also inconsistent with the fraud exception as articulated in the Restatements and rules in other states. As further grounds for its decision, the Supreme Court noted that the California Law Revision Commission completely ignored the *Pendergrass* Rule when it advised the Legislature in 1977 on case law to guide its revision of the parol evidence rule as eventually codified in the California Code of Civil Procedure § 1856.

With its decision in *Riverisland*, the California Supreme Court has significantly expanded the applicability of the fraud exception to the parol evidence rule under California law. Moreover, while both *Pendergrass* and *Riverisland* are in the borrower-lender situation, the decision is not so limited and will have far-reaching consequences in contract interpretation across the board, including in employment, consumer and competitor suits. The Court did note, however, that "that the intent element of promissory fraud entails more than proof of an unkept promise or mere failure of performance. We note also that promissory fraud, like all forms of fraud, requires a showing of justifiable reliance on the defendant's misrepresentation." The *Riverisland*

decision, therefore, does not necessarily open the flood gates to claims of fraud in contract cases, but rather forecloses the problematic distinction between promises that are consistent with the terms of a written instrument and those that are not; a party seeking to avoid contractual obligations on grounds of fraud will still face significant burdens of pleading and proof. That said, the *Riverisland* decision will likely result in fewer successful summary judgment motions by those seeking to enforce the written terms of an agreement because the existence and significance of an alleged oral promise will become a question of fact for the jury.

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