

ALERTS

Finance, Insolvency & Restructuring Alert - California Businesses Beware: California Supreme Court Expands The Fraud Exception Of The Parol Evidence Rule

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In a recent decision characterizing precedent as a seven decade “aberration,” the Supreme Court of California permitted plaintiff loan borrowers to introduce against a defendant banking institution parol evidence directly contradicting the very terms of the parties’ written loan agreement. The parol evidence supported the plaintiffs’ allegations that the defendant’s loan officer orally misrepresented to the borrowers the terms of a proposed written, integrated loan contract before the plaintiffs agreed to sign it. The new decision in effect removes a 70-year-old limitation on the fraud exception of the parol evidence rule.

A. Former Law: the “Pendergrass Limitation”

The parol evidence rule provides that evidence outside the terms of an integrated written agreement (such as oral statements about the agreement) may not be relied upon to alter or add to the agreement’s terms. In California, a significant statutory exception to the parol evidence rule provides that “[w]here the validity of the agreement is the fact in dispute, this section does not exclude evidence relevant to that issue.” Cal. Code Civ. Proc § 1856(f). Moreover, California law “does not exclude other evidence” regarding the validity of an agreement “to establish ... fraud.” Cal. Code Civ. Proc § 1856(g).

However, a 78-year-old Supreme Court of California case, *Bank of America Nat’l Trust & Savings Assn. v. Pendergrass*, 4 Cal. 2d 258 (1935) long imposed a confusing and challenging limit on the “fraud exception” to the parol evidence rule. Under Pendergrass, parol evidence was admissible only if it tended to prove some fraud in the inducement to enter the contract or some other fact independent of the contract’s terms. Thus, parol evidence of an oral promise that contradicted the terms of a subsequent written instrument was inadmissible, even for the purpose of contesting the instrument’s validity itself.

B. Riverisland: Expanding the Scope of the Fraud Exception of the Parol Evidence Rule

With its *Riverisland* decision, issued earlier this year, the Supreme Court of California dispensed with the Pendergrass limitation to the parol evidence rule’s fraud exception. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass’n*, 55 Cal.4th 1169 (2013). Now, parol evidence of representations contradicting the terms of a written agreement may be admitted as factual misrepresentations to prove fraud or negligence.

In *Riverisland*, plaintiff ranch-owners sought to restructure their loan

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agreement with the defendant, a credit association. At trial, plaintiffs introduced evidence that, two weeks before they signed the restructured loan agreement, the credit association's vice president told them that the new loan agreement's terms would extend the loan for two years in return for plaintiffs pledging two ranch properties as additional collateral.

Based on the terms as stated to them, the plaintiffs signed the restructured agreement at the locations tabbed for signature, without reading the document. The new terms actually contained in the document were far more burdensome than the plaintiffs had been told. The new terms provided that the plaintiffs pledged eight separate real property parcels as collateral, not two, and that the credit association would refrain from enforcement action for only three months, not two years.

The credit association initiated foreclosure activities after the plaintiffs missed making payments for a year. Ultimately, the loan was repaid and the foreclosure action against the plaintiffs was dismissed. Nonetheless, the plaintiffs subsequently filed an action against the credit association seeking damages for fraud and negligent misrepresentation. They argued that the credit association's vice president made promises that directly contradicted the written contract.

Relying on the Pendergrass limitation, the trial court granted summary judgment for the defendant, holding that the fraud exception to the parol evidence rule did not apply because the credit association's alleged oral promises were offered to contradict the loan agreement's express terms. The Court of Appeal reversed, reasoning that Pendergrass applied only to promissory fraud, and that false statements about the content of the agreement were not false promises, but rather were factual misrepresentations.

In affirming the Court of Appeal's decision, the Supreme Court of California took the opportunity to expressly overrule Pendergrass, calling it an "aberration" and characterizing it as "plainly out of step" with established California law even at the time Pendergrass issued in 1935.

C. What *Riverisland* Means For Business In California

Companies negotiating and entering into contracts in California must beware of the new exposure they face under *Riverisland*. Customers now enjoy another tool to dispute their contractual obligations: so long as they are willing to testify that the contract as written is not what they were orally promised, they may dispute the validity of the contract itself.

In response to this new threat, businesses should refrain as much as possible from oral communications about the substantive terms of proposed contracts. They also should keep contemporaneous written records of all communications with customers, especially of oral communications. When feasible, businesses should send customers written summaries of such oral communications – the 'confirming email' well known to litigators – to make clear what was said ... and what wasn't said.

To obtain more information or a copy of the decision, please contact the Barnes & Thornburg attorney with whom you work, or the following attorneys: David Allen at (310) 284-3860 or dallen@btlaw.com; Paul Laurin at (310) 284-3785 or plaurin@btlaw.com; or John W. Mills at (404) 264-4030 or jwmills@btlaw.com.

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