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ALERTS

Finance, Insolvency & Restructuring Real Estate Lending Alert: California Supreme Court Further Enhances Borrowers' Powers To Disavow Written Loan Agreements

June 24, 2013 | Atlanta | Chicago | Columbus | Delaware | Elkhart | Fort Wayne | Grand Rapids | Indianapolis | Los Angeles | Minneapolis | South Bend

In a recent decision characterizing precedent as a seven decade "aberration," the Supreme Court of California permitted plaintiffs, borrowers on a real estate collateralized loan, to introduce against defendant, a lending institution, parol evidence directly contradicting the terms of their written, integrated loan agreement. The parol evidence supported the plaintiffs' allegations that the defendant's loan officer orally misrepresented the loan agreement's written terms before the plaintiffs agreed to sign it.

This new decision, *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n*, 55 Cal.4th 1169 (2013), continues California's long tradition of protecting borrowers of loans secured by real estate.

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

The parol evidence rule – a doctrine that, in broad terms, prevents a party to a lawsuit from trying to alter or add to an integrated, written agreement's terms by introducing extrinsic evidence – has long carried with it a so-called 'fraud exception.' The fraud exception permits a court or jury to consider evidence outside the agreement's terms when the agreement's validity itself is in dispute, or to establish fraud.

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. 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.

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. 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 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

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Creditors' Rights, Restructuring and Bankruptcy 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.

B. Riverisland's Place In the History of California's Real Estate Collateralized Borrowers' Protections

California has long been known as a state highly protective of real estate borrowers. Not surprisingly, California's major protections of borrowers have been prompted by severe economic conditions. The Riverisland decision continues that tradition.

Under former law, borrowers who had proffered real estate as security faced not only foreclosure, but also actions for money judgments for deficiencies. Thus, suffering borrowers faced not only the loss of real estate collateral, including even their homes, but also the specter of unfettered litigation seeking money judgments that could result in the loss of other assets and even the garnishment of their wages. Indeed, lenders formerly had the option of ignoring foreclosure on real estate collateral – assets with a potentially highly depressed value in tough economic times – and instead proceeding directly to recover on the loan via a money judgment, without losing the real estate collateral. See, e.g., Martin v. Becker, 169 Cal. 301, 146 P. 665 (1915); see also Bernhardt, et al., CALIFORNIA MORTGAGES, DEEDS OF TRUST, AND FORECLOSURE LITIGATION, Vol. 1 § 5.2 (4th Ed. CEB 2012).

In response to such multi-pronged attacks by lenders, California and other states enacted a variety of borrower protections to regulate the process of real estate transactions. By enacting California Code of Civil Procedure §

726(a), California ended lenders' ability to collect debts from borrowers without first foreclosing on real property collateral by making clear that "[t]here can be but one form of action" for the recovery of any debt secured by real property. That "One Action Rule" requires lenders to seek foreclosure before seeking a money judgment.

More early protections of borrowers arose from the wreckage of the Great Depression in the 1930s. That economic disaster included the collapse of real estate values. In 1933, California enacted Code of Civil Procedure § 725(a), which ensured that the One Action Rule applied not only to mortgages, but also to deeds of trust – a common form of security that previously had been excluded from the One Action Rule. CALIFORNIA MORTGAGES, DEEDS OF TRUST, AND FORECLOSURE LITIGATION, supra, Vol. 1 at § 4.3.

California enacted several more protections during the Great Depression and its aftermath. Known as "Anti Deficiency Rules," these statutes limit lenders' menu of remedies. Codified at California Code of Civil Procedure §§ 580a-580d, these protections bar any deficiency judgment when a mortgagee elects to foreclose by way of a private, i.e. a non-judicial, foreclosure sale, impose a three (3) month time limit within which a judicially foreclosing creditor may seek a deficiency judgment, limit the amount of a deficiency judgment by a calculation based on the fair value of the property on the date of the foreclosure sale, prohibit deficiency judgments as to purchase money loans, and bar deficiency judgments in certain contexts involving short sales.

In the face of the so-called Great Recession following the collapse of the real estate market beginning in 2009, California law again responded by protecting borrowers. For example, Code of Civil Procedure § 580e was amended to bar deficiency judgments on junior deeds of trust after a short sale (previously, only first deeds of trust were covered).

Riverisland now provides borrowers who believe that they have been defrauded by verbal assurances of loan officers and other agents with a new, more confrontational, tool to defend their interests. As discussed above, the parol evidence rule will now be interpreted more broadly to permit the introduction of evidence of false statements about the content of a written agreement. As the plaintiffs in Riverisland can attest, this new development may assist borrowers in their never ending quest to avoid liability to lenders.

C. What Lenders Should Do to Protect Themselves

To limit their exposure to borrowers' post hoc contests of loan agreements, lenders should avoid making oral representations of the substantive terms of proposed contracts. Lenders also should keep contemporaneous written records of all communications with potential borrowers, especially of oral communications. Lenders should, as a matter of company policy, send customers written summaries of such oral communications – the 'confirming email' well known to litigators – whenever possible.

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; or Paul Laurin at (310) 284-3785 or plaurin@btlaw.com.