Changes to the Playing Field:

California Supreme Court Makes it More Difficult to Dispose of Any Contract Lawsuits Before Trial

BY ANDREW K. ALPER AND BOB BENJY

Attorneys Andrew Alper and Bob Benjy explain how the California Supreme Court's recent ruling in *Riverisland Cold Storage, Inc., et al. v. Fresno-Madera Production Credit Association* may drastically change the litigation landscape on contractual disputes, removing the ability of parties to dispose of the action by way of demurrers, motions to dismiss or summary judgment.

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The parol evidence rule provides that when parties enter into integrated contracts, extrinsic evidence may not generally be relied upon to alter or add to the terms of the writing. Integrated contracts are written agreements intended as a final expression of the agreed upon terms. The purpose of the rule is to ensure that the written final understanding of the parties is not subject to change. For example, under the parol evidence rule, where an integrated loan agreement provides that a loan shall mature on December 31, 2013, no party can subsequently seek to contradict the maturity date in the loan document by introducing evidence that there were oral representations made prior to or contemporaneously with the execution of the loan agreement that the real maturity date was July 1, 2014, and not the date in the loan agreement, which is December 31, 2013. Rather, the loan agreement should speak for itself and parties should not be able to use oral evidence to contradict the terms thereof. The parol evidence rule is codified in California in Code of Civil Procedure, §1856 and Civil Code, §1625 (and, of course, there are also parol evidence rules contained in California Commercial Code, §2202 and §10202 in California (Article 2A-202 elsewhere)).

California recognizes, however, a fraud exception to the parol evidence rule. A certain type of promissory fraud could be introduced to establish the invalidity of the written agreement, and evidence thereof is admissible notwithstanding the parol evidence rule. For example, one party could admit evidence to establish that the other party had represented to him that if he executed the agreement he would receive a particular benefit not discussed in the agreement itself.

However, in 1935 the California Supreme Court held in *Bank of America etc. Assn. v. Pendergrass* (1935) 4 Cal.2d 258, 263 that the limitation on the fraud exception states 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 a promise set forth in the writing*. In other words, if the loan agreement stated that the maturity date was December 31, 2013, a representation made by the lender that the maturity date was July 1, 2014, would be at direct variance with the terms of the written agreement and, therefore, the alleged fraud exception could not be used.

In *Pendergrass*, the borrowers fell behind on their loan payments and, at their bank's request, executed a new promissory note secured by additional collateral. The new note was payable on demand. Shortly thereafter, the bank took enforcement action, including seizing the collateral. In defending the action, the borrowers asserted that the bank had promised that it would not interfere with their farming operations for the remainder of the year and to take proceeds from those operations in payment during that year. The *Pendergrass* court noted that the alleged promise was in direct contravention to the terms of the note, which stated it was a demand note and would not allow the evidence to prove fraud with respect to the terms of the new note.

Some 78 years after *Pendergrass*, with many cases over the years relying on that decision to the exclude evidence contradicting the terms of integrated agreements, the Supreme Court all of a sudden concluded *Pendergrass* was an aberration, stating that *Pendergrass* failed to account for the fundamental principle that fraud undermines the essential validity of the parties' agreement.

Thus, for the last 78 years, lenders relied on the sanctity of written documents to fend off borrowers' and guarantors' claims of alleged oral representations by lenders that contradicted the express terms of loan agreements as a result of the parol evidence and certain evidentiary presumptions (i.e., in California Evidence Code §622 where facts in writing are conclusively presumed to be true between parties and their successors in interest).

On January 14, 2013, the playing field was changed. In *Riverisland Cold Storage, Inc., et al. v. Fresno-Madera Production Credit Association* (2013) 55 Cal.4th 1169, the California Supreme Court overturned *Pendergrass*. In *Riverisland*, the plaintiffs fell behind on their loan payments to the lender. They restructured their debt in an agreement and confirmed that the outstanding loans had a total deficiency of $776,380.24. Under the new agreement, the lender promised it would take no enforcement action until a certain date, if the plaintiffs made specified payments. As additional collateral, the borrowers pledged eight separate parcels of real property. The borrowers did not make the payments. Thereafter, the lender initiated a non-judicial foreclosure of the properties. Plaintiffs ultimately repaid the loan in full. Subsequently, the borrowers filed a lawsuit against the lender seeking damages for fraud and negligent misrepresentation and included causes of action for rescission and reformation of the restructuring agreement. They alleged that the lender's vice president met with them two weeks before the agreement was signed and told them that the lender would extend the loan for two years in exchange for additional collateral consisting of two ranches. The borrowers further contended that when they signed the agreement, the lender assured them that its term was two years and the two ranches were the only additional security. However, the contract itself contemplated only three months of forbearance by the lender and identified eight parcels as additional collateral, not two. The borrowers did not read the agreement but simply signed it at the locations tabbed for signature.

The lender moved for summary judgment and contended that the parol evidence rule barred any evidence of any representations contradicting the terms of the written agreement. The borrowers argued that the lender's misrepresentations were admissible under the fraud exception to the parol evidence rule. Citing *Pendergrass*, the court granted summary judgment dismissing the fraud claims made by the borrowers. The Court of Appeal then reversed the decision contending that the false statements about the contents of the agreement itself were factual misrepresentations beyond the scope of the *Pendergrass* rule. The Supreme Court affirmed the Court of Appeal and, in so doing, overturned *Pendergrass*.

In reaching its decision to overrule *Pendergrass*, the Supreme Court reflected on several problems with that decision. It reasoned that the statutes codifying the parol evidence rule do not include any limitation on the scope of the fraud exception and the majority of other states do not limit that exception. The court explained that *Pendergrass* potentially renders the parol evidence rule a shield to protect misconduct or mistake. The court further expressed concern that lower courts were having difficulty applying *Pendergrass* and its progeny resulting in uncertainty in case law. The court also noted that in *Fleury v. Ramacciotti* (1937) 8 Cal. 2d 660, a decision rendered just two years after *Pendergrass*, the Supreme Court had ruled that "fraud may always be shown to defeat the effect of an agreement."

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Thus, going forward, any borrower could contend that there was a prior or contemporaneous representation made by the lender at variance with the written agreement and the borrower was misled into signing the agreement and, therefore, the loan agreement should not be enforced. On the other hand, the lender will now contend that if the borrower is trying to use the fraud exception to the parol evidence rule, then the borrower still has to prove fraud. One of the elements of a fraud cause of action is that the borrower would have had to reasonably and justifiably rely on the misrepresentation to his, her or its detriment and that the borrower had no knowledge of the falsity of the representation being made. However, given that the language in the contract states a fact diametrically opposed to what the borrower would contend is fraudulent, the borrower would have a difficult and uphill battle proving the reasonable and justifiable reliance element of the fraud cause of action because the express terms of the agreement directly contradict the alleged lender representation (i.e., the maturity date in the agreement is December 31, 2013, but the lender is alleged to have made a prior oral representation that the loan would mature on July 1, 2014). But what if the borrower states he or she never read the agreement at the time it was executed? Is this the new way to avoid the problem the borrower would have in proving fraud and borrower's reasonable reliance?

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As a result of the foregoing, *Riverisland* may drastically change the litigation landscape on contractual disputes removing the ability of parties to dispose of the action by way of demurrers, motions to dismiss or summary judgment. The parties now have the ability to defeat summary judgment motions by submitting declarations alleging that another party to the agreement represented that the terms of a contract were different than what was ultimately included in the instrument. This is true even where the representations contradict the terms of the integrated writing and notwithstanding that the party asserting fraud admits that he, she or it did not read the agreement prior to execution. The law has always been that absent some fraud in the execution, a party is responsible for reading the contract that he, she or it signs (See, e.g., *Oakland Bank of Commerce v. Washington* (1970) 6 Cal. App.3d 793, 799). Practically, this means there will be an exponential increase in cases that must be tried and a judge or a jury will be tasked with weighing the evidence of fraud to determine whether the agreement is enforceable. Combined with the fact that California's budgetary problems, which have and continue to result in the closure of many courtrooms, this means that such cases will take longer to resolve or go to trial. As a result, alternative dispute resolution, compromise and settlement are more attractive than before because, among other reasons, such alternatives remove the uncertainty associated with a he-said, she-said swearing contest before a jury. This is particularly true in today's lending environment, where juries tend to be hostile towards lenders that the public believes are taking advantage of innocent borrowers and guarantors.

California also has a special statute involving judicial reference. That is, using the appropriate language in contracts, parties have the ability to rent their own judge outside of court. Once the judge renders his ruling, it will be affirmed by the court and then can be appealed, enforced or otherwise dealt with. In a judicial reference matter, there is no jury. In addition, if a lender is so inclined, arbitration is another quick method of proceeding. There are pros and cons of arbitration that are not the subject of this article. It is recommended that lenders and lessors avoid the delay associated with pretrial motions not being granted, the delay in having these motions heard (which can take up to six months in some California courts) and the uncertainty regarding juries by using either judicial reference or arbitration clauses in their contracts. Such clauses are valid and enforceable as a matter of law so long as they are conspicuous and voluntarily executed.

To further reduce the potential negative impact of *Riverisland*, whenever credit is extended or renewed, the forbearance, extension and/or modification agreements should include recitals acknowledging the debt, the amounts owed and the fact that there are no defenses, claims or causes of action and obtain releases of the lender and its predecessors, successors and assigns. The execution of a forbearance, extension or modification agreement is also a good opportunity to add a judicial reference or arbitration clause. Proceeding in this manner will not necessarily guarantee success in litigation given the judicial landscape as it is, but there are certain steps a lender can take in order to mitigate the effect of *Riverisland*. m

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