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ARTICLE

NOT WORTH THE PAPER IT'S PRINTED ON? Strategies for Dealing with the Fraud Exception to The Parol Evidence Rule

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This article explores possible measures that parties to commercial transactions and their attorneys can take to help ensure greater contract certainty when fraud claims of one type or another are not barred by the parol evidence rule. In California, as in a majority of other states, the parol evidence rule does not bar claims for fraudulent misrepresentations or promises at variance with the terms of a written contract. This presents a dilemma for parties involved in retail leasing, financing and other commercial transactions. Most lenders, landlords and other institutional and corporate parties do not want their loan documents, leases, and other agreements to be impaired or voided, in whole or in part, due to actual or alleged representations or understandings not reflected in the negotiated written documents.

A. *SUMMARY OF EXISTING LAW AND EXPLANATION OF THE DILEMMA.*

To comprehend the dilemma more fully and better evaluate possible solutions, it is helpful to have a basic understanding of the parol evidence rule. It is also helpful to have a working understanding of the

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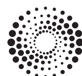

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fraud exception to the parol evidence rule. The following summary is not an exhaustive analysis of the applicable law. It should, however, assist the parties and their counsel involved in negotiating retail transactions to understand the potential problems that fraud claims (whether legitimate or not) pose to parties who want to be able to rely on the express terms of their negotiated agreements. The summary also demonstrates why there is likely no universal solution to the problems such fraud claims present, nor one single way to prevent such fraud claims from being raised in the first place.

1. *Parol Evidence Rule.*

In the absence of fraud or mistake, it is a basic tenet of contract law that parties to a written agreement voluntarily executed and supported by consideration should be bound by it. To this end, the parol evidence rule is intended to protect the integrity of written contracts by making their terms the exclusive evidence of the parties' agreement.[1] The rule provides that when parties enter an integrated written agreement, extrinsic evidence may not be relied upon to alter or add to the terms of the writing.[2] Parol or extrinsic evidence may consist of oral or written promises, representations, or agreements made before or contemporaneously with the execution of the written contract under consideration, which promises, representations, or agreements are not repeated or otherwise referenced in the contract. [3] In short, parol evidence should be inadmissible to show that the parties meant something other than what they stated in their written contract.[4]

An agreement may be integrated either in whole or in part.[5] A fully integrated agreement is one that contains an integration clause. In substance, such clauses state that the contract is the final expression of the parties' agreement with respect to the subject matter thereof, and all prior understandings, representations, agreements, or communications pertaining to the subject matter of the agreement are not enforceable. A contract is deemed partially integrated with respect to terms that are expressly set forth in the written agreement. [6] The parol evidence rule applies to the integrated portion of a partially integrated contract.[7]

The effectiveness of the parol evidence rule has, however, been undercut to a large degree by judicially or statutorily created exceptions to the rule. Such exceptions include the right to introduce extrinsic evidence to show that the contract in question was induced by fraud, mistake, or duress.[8] For those who value contract certainty, the fraud exception can be particularly troublesome due to its relatively expansive scope.

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2. *The Fraud Exception to the Parol Evidence Rule.*

In most states, including California, evidence of fraud of any type is not precluded by the parol evidence rule.[9] In explaining the fraud exception as it exists in the majority of states (the "majority rule"), courts have stated that the parol evidence rule should not be used as a shield against fraudulent conduct. [10] Where the majority rule is followed, the parol evidence rule, as a doctrine of contract law, has no application to tort claims.[11] In such states, even claims for negligent misrepresentation are not precluded by an integrated contract.[12]

Where the majority rule has been adopted, the usefulness of contractual integration clauses is significantly reduced. Except in rare circumstances, whether a party's reliance on false representation is reasonable or justified is a question of fact.[13] Thus, where the majority rule is in effect, parties being sued on fraud claims at variance with contractual provisions are unlikely to be able to resolve the action without a court or jury trial, absent a settlement or a decision by the plaintiff to dismiss the case. In California, however, the so-called "*Pendergrass* rule" for more than 80 years excluded extrinsic evidence of an intended meaning that contradicted the express terms of the written document.[14]

As a result of the California's Supreme Court's 2013 decision in *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*,[15] California now falls squarely within the group of states adhering to the majority rule. In *Riverisland*, plaintiffs restructured their debt with the lender in an agreement they allegedly did not read, that turned out to be significantly different than what they had negotiated in person. The California Supreme Court overruled the *Pendergrass* limitation on the fraud exception, stating "[I]t was never intended that the parol evidence rule should be used as a shield to prevent the proof of fraud."[16] California law on this issue can be summarized as follows: A party claiming fraud in the inducement may introduce parol evidence in support of the party's claim, regardless of whether an integration clause exists and/or the parol evidence contradicts an explicit provision of the written contract or lease.[17] The exception applies regardless of the sophistication of the parties to the transaction,[18] and even if the alleged misrepresentation is contained only in a letter of intent rather than the contract itself.[19]

The *Riverisland* decision involved a claim of fraud in the negotiation of a commercial loan transaction. Other courts have followed *Riverisland* in lease transactions. Allegations by tenants contending the landlord or its agents made extrinsic misrepresentations concerning the

condition of the premises, the size of the premises, major tenant commitments to a project or shopping center, and the amount of common area maintenance charges owed have all been held not to be barred by the parol evidence rule.[20]

Even after *Riverisland*, it is important to note that in California, the party claiming fraud cannot overcome the parol evidence rule unless it can plead *and prove* justifiable reliance.[21] Contractual language, including disclaimers concerning the lack of any reliance on extrinsic representations, is only a factor to be considered in determining whether justifiable reliance exists.[22] In *Riverisland,* the California Supreme Court also suggested that proof of fraudulent intent is necessary for the fraud exception to apply.[23] Nonetheless, to date, the lower courts have largely ignored this portion of the *Riverisland* opinion.[24]

B. *POSSIBLE MEASURES TO REDUCE AND PROTECT AGAINST FRAUD CLAIMS BEING SUCCESSFULLY ASSERTED TO ALTER OR VARY CONTRACTUAL TERMS.*

Whatever one thinks of the benefits or drawbacks of the parol evidence rule, it is clear that in most cases the fraud exception can be used to overcome integration clauses. This means that the parties to a contract or lease cannot rely exclusively on the terms thereof to protect their interests. As a result, those who want to enforce their contracts and leases as written with some degree of certainty should devote some critical thought as to how to achieve that goal. Below are some ideas and thoughts that may help in such an analysis.

1. *Limit Pre-Contract Communications.*

In California, where the majority rule now holds sway, the best way to avoid fraud claims at variance with the terms of a written contract or lease is to eliminate or limit, whenever possible, pre-contract representations and factual statements concerning the contemplated transactions beyond the minimum deal points (such as, in a lease transaction, the location of the premises, the amount of base rent owed, and the names of the parties). Communications of any type, including e-mails, broker brochures and other listing or advertising materials, and letters of intent, should be scrutinized to limit or omit extraneous information. In the case of a new retail project, a landlord may want to avoid providing information, either directly or through its agents or representatives, that will not be part of the final lease agreement. This includes, for example, CAM estimates, the names of anticipated

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or potential anchor tenants, the tenant's ability to obtain any permits needed for it to operate, or the overall leasable square footage that will be contained in the project once completed. Similarly, a tenant in a retail project may want to avoid pre-contract representations concerning its plans to open for business, or construct tenant improvements, unless required by the terms of the lease. In a loan transaction, beyond the minimum terms of principal amount, interest rate, fees, and collateral description, the negotiations of other terms should be confined to contractual documents rather than a series of other communications.

From a legal risk avoidance perspective, it also would be a good idea for companies and organizations to limit the number of individuals that are permitted to engage in direct communications with the other side during contract or lease negotiations. Such individuals should fully understand the risks involved in making inaccurate statements as part of a lease or other contract negotiations. As other commentators have noted, absent a legal duty to do otherwise, a party to a contract or lease should also avoid making statements about the contents of the agreement, or the meaning of particular provisions therein, to the other party prior to the time that the agreement has been fully executed and delivered.[25]

2. *Factual Statements and Estimates When Made Should be Accurate in All Material Respects.*

While the above advice about minimizing or eliminating extraneous communications is sound, the realities of commercial transactions require that a more robust and inclusive series of communications need to occur in the course of a meaningful negotiation of a mutually agreeable contract. Ultimately, this means that interim representations and statements need to be made for many deals to get done, even though they may result in allegations of fraud, however valid, if one of the parties later finds it advantageous to assert this. Recognizing that this is likely to occur, great care should be taken to make sure that such representations and statements are accurate in all material respects. If estimates are required, they should be made in good faith and the basis for the same explained. Such an explanation should make it more difficult for the other party to claim that they were misled by the prior estimate, and minimize claims of fraudulent intent. Before the contemplated agreement or contract is executed, prior communications, including the term sheet, expression of interest or letter of intent, and e-mails, should be reviewed to confirm that any prior representations or factual statements

contained therein are accurate. If not, the inaccuracies should be corrected and the correction acknowledged by the other party either as part of the written agreement or in a separate writing.

3. ***Consider Including Due Diligence / Inspection Contingencies.***

Some fraud claims, such as those involving the condition of a premises, or the ability of the premises to be used for a specified purpose, may be eliminated or made more difficult to assert through the use of due diligence or inspection contingencies. Granting a party to a lease or purchase and sale transaction a right to terminate a transaction for any reason or no reason prior to the expiration of an inspection period may result in some up-front uncertainty and additional costs. Any additional costs, however, will in almost all instances be far less than those arising out of a fraud action. Due diligence periods also allow for previously non-disclosed problems with a property to be discovered. Once discovered during a due diligence or inspection period, mutually acceptable business solutions addressing the problems can be reached before each side has become too invested in the transaction for such to readily occur.

4. ***Robust Integration Clauses.***

A good integration clause, including disclaimers stating that no party is relying on extrinsic representations or promises, may help to show that the party asserting the fraud or misrepresentation in question did not reasonably or justifiably rely on the same in entering into the subject transaction. To bolster such reliance based arguments, integration clauses should be made more conspicuous. To that end, it may be advised for integration clauses to be written in all caps, bolded, and/or separately initialed, depending on the nature of the contract and the relationship of the parties. Ideally, the clauses should also be coupled with acknowledgments that each party has read the contract or lease in question and was given the opportunity to have it reviewed by counsel of said party's choosing.

5. ***Estoppel Certificates.***

Some practitioners have suggested, and certain institutional landowners and lenders are now requiring at the signing table, the execution of a separate declaration or estoppel certificate stating, among other things, that the executing party: (i) is not relying on any promise or representation not contained within the contract; (ii) has read and understands the content of the contract or lease; (iii) understands that preliminary discussion or negotiating drafts have been superseded

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by the final executed document; and (iv) has had, or was given the opportunity to have, its counsel review the contract or lease.[26] As a general matter, courts have favorably viewed estoppel certificates and permitted parties involved in transactions to rely on the same so as to preclude claims contrary thereto.[27] Whether a court would decide that such an estoppel certificate executed at the same time as the contract or lease in question overrides and precludes the application of the fraud exception is unclear, or at least the author is not aware of any reported cases so holding. One would expect that a party signing such an estoppel would argue that it cannot be estopped by an instrument obtained by fraud and that the estoppel certificate should not be viewed as being legally distinct from any contemporaneously executed contract or lease.[28]

It would seem, however, that the chances of such estoppel certificates being used to defeat parol based fraud claims would be significantly increased if: (i) the delivery of estoppel certificate is made a post-execution event; and (ii) the estoppel form in question includes a blank space and instructions similar to the following: "If you are relying on any alleged representations and/or promises not contained in the written agreement as part of the reason for you deciding to sign the written agreement, please specify the exact representations and/or promises in question in the space provided below. If there are no such representations and/or promises, please specify 'None.'" If the estoppel certificate is made a post execution event, the party receiving the same should be granted the right to terminate the lease or contract in question if the estoppel is either not received or received in a form not acceptable to it. Under such circumstances, where no such extrinsic representation or promise is included in the estoppel as signed and delivered, it would appear to be an uphill challenge for the party claiming fraud to assert that its reliance on the alleged fraud was reasonable.

6. *Initialing or bolding "material terms".*

Some practitioners also have suggested that to avoid judicial sidestepping of important "deal points" based on allegations of fraud, the written instrument should use bold or all capital letters to highlight "key points" or even require that those particular provisions be separately initialed. While this approach may have an appeal to litigation lawyers with an eye towards proof that the challenging party understood the agreement, the problem is that what is "material" often is evident only when the dispute arises. Singling out particular clauses for attention only invites the other party and the courts to argue that they misunderstood another provision that was not expressly initialed, and carries the further risk that the other issues will be deemed immaterial

or dispensable in a given future dispute. While this approach may be helpful in some cases, it may pose more problems than it resolves, in practice. An exception may be the integration clause, where the effort is to assure judicial recognition that there are no other material terms besides those set forth in the written contract.

C. *CONCLUSION.*

While all of the above suggestions involve the implementation of additional processes or documentation, the time necessary for the implementation of the same should, for the most part, be relatively limited. The suggestion to make diligent efforts to ensure that all pre-contract factual statements and representations are materially accurate is not only legally prudent, but it is also a good business practice. People want to engage in transactions with individuals and companies that they can trust, and they want to be able to rely on agreements that have been signed. Whatever the burdens imposed by implementing one or more of the suggestions, such implementation is justified by the current state of the law for those who value contract certainty.

NOTES

1. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n*, 55 Cal. 4th 1169, 1171, 151 Cal. Rptr. 3d 93, 291 P.3d 316 (2013).
2. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n*, 55 Cal. 4th at 1171 (citing *Casa Herrera, Inc. v. Beydoun*, 32 Cal. 4th 336, 343, 9 Cal. Rptr. 3d 97, 83 P.3d 497 (2004); *Snyder v. Lovercheck*, 992 P.2d 1079, 1086 (Wyo. 1999) (citing *Union Pacific Resources Co. v. Texaco, Inc.*, 882 P.2d 212, 220 (Wyo. 1994))).
3. *Snyder v. Lovercheck*, 992 P.2d 1079, 1086 (Wyo. 1999).
4. For this reason, where a contract term is ambiguous, or susceptible of more than one meaning, parol evidence may be used to help explain what the parties intended by its use. See, e.g., *Southern Pacific Transportation Co. v. Santa Fe Pacific Pipelines, Inc.*, 74 Cal. App. 4th 1232, 1241, 88 Cal. Rptr. 2d 777 (1st Dist. 1999).
5. Restatement Second, Contracts §209(1).
6. *Founding Members of the Newport Beach Country Club v. Newport Beach Country Club, Inc.*, 109 Cal. App. 4th 944, 953, 135 Cal. Rptr. 2d 505 (4th Dist. 2003).
7. *Founding members of the Newport Beach Country Club v. Newport Beach Country Club*, 109 Cal. App. 4th at 953.
8. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 55 Cal. 4th at 1174-1175 ("Evidence to prove that the instrument is void or voidable for mistake, fraud, duress, undue influence, illegality … is admissible.").
9. See *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 55 Cal. 4th 1169 (citing to, among other cases, *Howell v. Oregonian Pub. Co.*, 85 Or. App. 84, 735 P.2d 659 (1987); *Formento v. Encanto Business Park*, 154 Ariz. 495, 744 P.2d 22 (Ct. App. Div. 2 1987); *W.W. Vincent and Co. v. First Colony Life Ins. Co.*, 351 Ill. App. 3d 752, 286 Ill. Dec. 734, 814 N.E.2d 960 (1st Dist. 2004)) (integration clause does not bar a claim of fraud based on statement not contained in the contract).
10. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n*, 55 Cal. 4th 1169, 151 Cal. Rptr. 3d 93, 291 P.3d 316 (2013); *Howell v. Oregonian Pub. Co.*, 85 Or. App. 84, 735 P.2d 659 (1987).

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11. *W.W.Vincent and Co. v. First Colony Life Ins. Co.*, 351 Ill. App. 3d 752, 286 Ill. Dec. 734, 814 N.E.2d 960 (1st Dist. 2004).
12. See, e.g., *Thrifty Payless, Inc. v. Americana at Brand, LLC*, 218 Cal. App. 4th 1230, 1241-1242, 160 Cal. Rptr. 3d 718 (2d Dist. 2013) (Thrifty can sue for both intentional and negligent misrepresentation based upon Americana's grossly inaccurate pre-lease estimates); *Formento v. Encanto Business Park*, 154 Ariz. 495, 744 P.2d 22, 26 (Ct. App. Div. 2 1987) (parol evidence rule does not apply, because fraud is a recognized exception to the rule, and there is no difference in the result that obtains from either a fraudulent or a negligent misrepresentation); *Keller v. A.O. Smith Harvestore Products*, Inc., 819 P.2d 69, 72-73 (Colo. 1991).
13. See, e.g., *Thrifty Payless Inc. v. Americana at Brand, LLC*, 218 Cal. App. 4th at 1239.
14. *Bank of America Nat. Trust & Savings Ass'n v. Pendergrass*, 4 Cal. 2d 258, 263, 48 P.2d 659 (1935) (overruled by, Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Ass'n, 55 Cal. 4th 1169, 151 Cal. Rptr. 3d 93, 291 P.3d 316 (2013)).
15. 55 Cal. 4th 1169 (2013).
16. *Ferguson v. Koch*, 204 Cal. 342, 347, 268 P. 342, 58 A.L.R. 1176 (1928).
17. See *Thrifty Payless, Inc., infra*.
18. See *Julius Castle Restaurant Inc. v. Payne*, 216 Cal. App. 4th 1423, 1442, 157 Cal. Rptr. 3d 839 (1st Dist. 2013).
19. See *Thrifty Payless Inc. v. Americana at Brand, LLC*, 218 Cal. App. 4th at 1241-1242.
20. *Thrifty Payless, Inc. v. The Americana at Brand, LLC*, 218 Cal. App. 4th at 1241-1242 (parol evidence did not bar alleged false statement regarding amount of CAMs owed contained in a letter of intent); *Hinesley v. Oakshade Town Center*, 135 Cal. App. 4th 289, 37 Cal. Rptr. 3d 364 (3d Dist. 2005) (claim of false representation that national tenants would be leasing space in the a mall were not barred by a contractual disclaimer to the contrary); *McClain v. Octagon Plaza, LLC*, 159 Cal. App. 4th 784, 71 Cal. Rptr. 3d 885 (2d Dist. 2008) (stipulation in a contract that tenant had verified square footage of premises do not preclude fraud claim that the size of the premises was falsely represented both in the lease and prior to the signing thereof); *Julius Castle Restaurants, Inc. v. Payne*, 216 Cal. App. 4th at 1442 (parol evidence was admissible to show that lessor had represented that the premises were in good condition and that lessor would maintain the same despite the existence of an integration clause and "as-is" language in the lease).
21. *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 55 Cal. 4th 1169 at 1183.
22. *Hinesley v. Oakshade Town Center*, 135 Cal. App. 4th at 296-297.
23. See *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 55 Cal. 4th at 1183 (stating that unkept, but honest, promises or subsequent failure to perform a pre-contract promise are not sufficient to overcome the parol evidence rule).
24. See *Thrifty Payless Inc. v. Americana at Brand, LLC*, 218 Cal. App. 4th at 1241-1242.
25. Kredior & Piotti, *Mum's the Word: Why Saying Too Much May Invalidate a Contract*, California Litigation, Vol 27, No. 2.
26. Kredior & Piotti, *Mum's the Word: Why Saying Too Much May Invalidate a Contract*, California Litigation, Vol 27, No. 2.
27. See, e.g., *Plaza Freeway Ltd. Partnership v. First Mountain Bank*, 81 Cal. App. 4th 616, 96 Cal. Rptr. 2d 865 (4th Dist. 2000) (tenant bank was estopped to assert that lease termination date was other than the date stated in the estoppel certificate and, as a result, the tenant could not exercise any option rights).
28. See *Vai v. Bank of America National Trust & Savings Ass'n*, 56 Cal. 2d 329, 15 Cal. Rptr. 71, 364 P.2d 247 (1961) (stipulation in a settlement agreement that it was not entered into in reliance on any promises or representations not contained therein did not preclude a party thereto from asserting that it was entered into by fraud).

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