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Promises to Keep—Lender Beware: California Supreme Court Expands Parol Evidence Fraud Exception

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In 1935, the California Supreme Court in *Bank of America National Trust and Savings Ass'n v. Pendergrass*[1] prohibited a borrower from introducing external or parol evidence to demonstrate fraud in connection with an agreement if the evidence directly contradicted the terms of the written agreement. In *Pendergrass*, the California Supreme Court refused to allow the borrowers to present evidence that loan officers had promised one thing while the agreement said something else, finding that parol evidence could not be used to prove fraud where it directly contradicted the written terms of the agreement. Seventy-five years later, however, the California Supreme Court recently overruled this long-standing jurisprudence in *Riverisland Cold Storage v. Fresno-Madera Production Credit Ass'n*, holding that the rule departed from established California law at the time it was decided and provided a potential shield for wrongdoers. Additionally, the *Riverisland* Court noted that the holding in *Pendergrass* was contrary to the language of the statute regarding parol evidence and the laws of other states.[2] Thus, with one fell swoop, the California Supreme Court potentially loosened the litigation flood gates by allowing borrowers to introduce parol evidence of alleged promises, even if those alleged promises directly contradict the terms of a written agreement.

While the impact of the *Riverisland* decision remains to be seen, lending institutions should take the opportunity to proactively evaluate and modify their workout processes to protect against a potential future *Riverisland* argument.

California Parol Evidence Rule

California Civil Code Section 1625 provides that "[t]he execution of a contract in writing, whether the law requires it to be written or not, supersedes all the negotiations or stipulations concerning its matter which preceded or accompanied the execution of the instrument." California Code of Civil Procedure Section 1856(a) supplements California Civil Code Section 1625 by codifying the parol evidence rule, stating that a final agreement "cannot be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement."

At the heart of the *Pendergrass* and *Riverisland* decisions are California Code of Civil Procedure Sections 1856(f) and (g). Section 1856(f) provides "[w]here the validity of the agreement is the fact in dispute, [Section 1856] does not exclude evidence relevant to that issue." Section 1856(g) provides further: "[Section 1856] does not exclude other evidence of the circumstances under which the agreement was made or ... to explain an extrinsic ambiguity or otherwise interpret the terms of the agreement, or to establish illegality or fraud."

Pendergrass Rule

Pendergrass involved a textbook restructuring scenario. The borrowers fell behind on repayment of their financial obligations owed to the bank. The borrowers and the bank executed a new promissory note, which was secured by additional collateral and payable on demand. Ultimately, the borrowers failed to keep repayment of the debt obligations current and the bank foreclosed on the collateral and initiated litigation to enforce the note.[3]

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[1] 4 Cal. 2d 258 (1935).

[2] 55 Cal. 4th 1169, 1172 (2013).

[3] *Pendergrass*, 4 Cal. 2d at 259-62.

In defense, the borrowers argued that, notwithstanding the terms of the written agreement, as part of the restructuring the bank orally promised not to interfere with their farming operations for the remainder of the year and to accept the proceeds from their operations as payment. The borrowers further argued that the bank had no intention of keeping the above-mentioned promises, but rather made them for the fraudulent purpose of obtaining the new note and additional collateral.[4]

The *Pendergrass* Court did not consider the borrowers' evidence regarding the bank's alleged oral promises, holding that "[o]ur conception of the rule which permits parol evidence of fraud to establish the invalidity of the instrument is that it 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."[5]

New *Riverisland* Rule

The facts in *Riverisland* are very similar to those in *Pendergrass*. The borrowers fell behind on their loan payments to the bank. The borrowers' loan obligations were restructured in an agreement dated March 26, 2007. The restructured loan agreement provided that the bank would forbear from exercising any of its remedies until July 1, 2007, provided that the borrowers made specific payments. In consideration of the restructured obligations, the agreement contained a pledge from borrowers of eight separate parcels of real property. In addition to executing the agreement, the borrowers initialed pages that included the legal description of the property.[6]

Eventually, the borrowers defaulted under the restructured loan agreement and the bank recorded a notice of default. Foreclosure proceedings were vacated after the borrowers repaid the loan.[7]

The borrowers subsequently sued the bank seeking damages for fraud, negligent misrepresentation, rescission and reformation of the restructured loan agreement. They argued that two weeks before the restructured loan agreement was signed, the bank's vice president represented to them that under the terms of the new agreement the maturity date would be extended for two years in exchange for a security interest in two additional parcels. The borrowers argued further that the bank's vice president assured them at signing that the term of the restructured loan was a two-year maturity extension in exchange for a security interest in two ranches. The borrowers admitted that they executed the restructured loan agreement without reading the agreement.[8]

Relying on the rule set forth in *Pendergrass*, the lower court prohibited the borrowers from introducing evidence of the vice president's representations, holding that the fraud exception to the parol evidence rule does not allow parol evidence of promises that contradict terms in a written agreement.

On appeal, the California Supreme Court overruled *Pendergrass* and its progeny, citing that it is "out of step with established California law."[9] In particular, the Court noted that although the *Pendergrass* rule has been established jurisprudence for 75 years, courts have followed it "with varying degrees of fidelity."[10] The main criticism of the *Pendergrass* rule has been that it is at odds with California Code of Civil Procedure Section 1856, which the Court noted provides that a showing of fraud may invalidate a contract.[11] The Court also referenced the California Law Revision Commission's comment in 1977 that "[a]s the parol evidence rule exists in California today, it bears little resemblance to the statutory statement of the rule."[12]

Not only is the *Pendergrass* decision at odds with California statutory law, the Court noted that it is a "divergence" from the rules promulgated by the restatements, the rule of law in a majority of other states, and opinions of scholarly commentators.[13]

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4 *Id.* at 261.

5 *Id.* at 263.

6 *Riverisland*, 55 Cal. 4th at 1172-73.

7 *Id.* at 1173.

8 *Id.*

9 *Id.* at 1181.

10 *Id.* at 1176.

11 *Id.*

12 *Id.* at 1178.

13 *Id.* at 1180.

Additionally, the Court noted that the *Pendergrass* rule may actually "further fraudulent practices" by allowing the parol evidence rule to be "a shield to protect misconduct or mistake"—noting that fraud, mistake or illegality are unlikely to be bargained over or documented.[14] Finally, the Court reviewed the authorities underlying the *Pendergrass* rule and determined that they "provide[d] little support for the rule."[15]

In the end, the Court proclaimed *Pendergrass* "an aberration"[16] and held that "[p]arol evidence is always admissible to prove fraud, and it was never intended that the parol evidence rule should be used as a shield to prevent the proof of fraud."[17]

Conclusion and Recommendations

Lending institutions should be aware of, and take proactive steps to protect against, the *Riverisland* decision. In particular, lending institutions should evaluate their internal processes as they relate to transitioning loans to a workout group to ensure that there are uniform policies regarding communications with borrowers as they work toward restructuring obligations. Particular care needs to be paid when interacting with unsophisticated borrowers, in that all communications need to be consistent, agreements should include specific representations that borrowers have reviewed all material terms, and lenders should ensure that borrower(s) or their counsel have actually done so. Additionally, lending institutions should review and modify, if needed, their form agreements, term sheets and closing letters, to make clear that no terms or statements are binding unless and until reduced to writing signed by an authorized representative of the lending institution.

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[14] *Id.* at 1177.

[15] *Id.* at 1181.

[16] *Id.* at 1182.

[17] *Id.* t 1180-81, citing *Ferguson v. Koch*, 204 Cal. 342, 347 (1928).

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