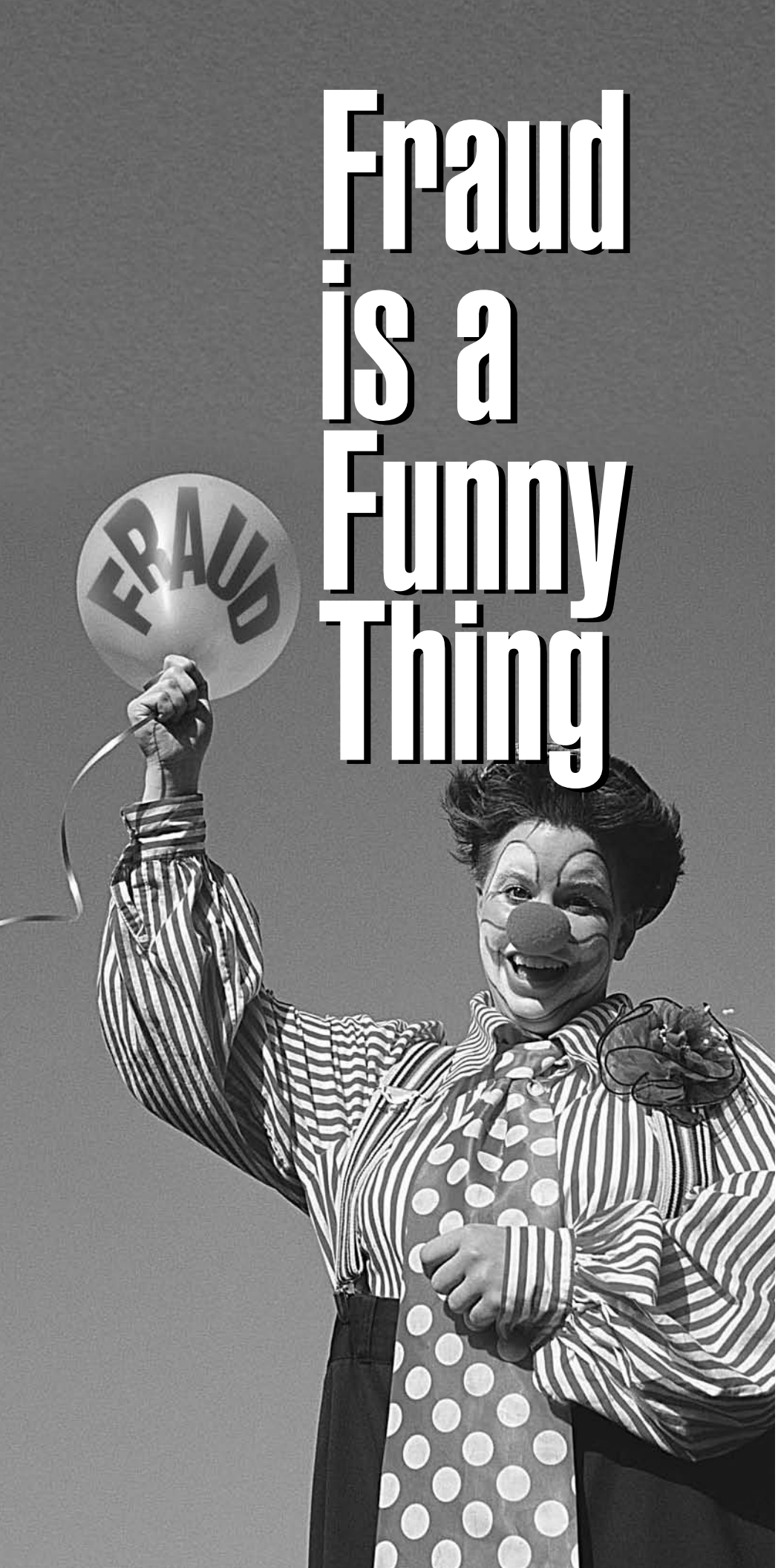
Fraud is a Funny Thing



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by Todd Green

I. Introduction

There is a tension between the policy favoring the certainty of contracts and that protecting contracting parties from obligations procured through fraud. That tension manifests itself when courts grapple with the question of what effect, if any to give to contractual provisions in the face of a claim seeking to rescind the contract based on fraud in the inducement. An examination of how two particular, and common, contractual provisions are treated in the face of such a claim highlights this tension. These clauses are integration clauses and arbitration clauses.

II. The Parol Evidence Rule, the "Exception" and the Exception to the Exception

A. The Parol Evidence Rule

The parol evidence rule, codified in §1856, subdivision (a), of the California Code of Civil Procedure, provides: "Terms set forth in a writing intended by the parties as a final expression of their agreement with respect to such terms as are included therein may not be contradicted by evidence of any prior agreement or of a contemporaneous oral agreement." Cal.Civ.Proc.Code §1856.

The parol evidence rule is not merely a rule of evidence concerned with the method of proving

an agreement; it is a principal of substantive law. It reflects a policy that elevates the stability of written commercial transactions over claims of differing oral agreements: "[W]hen the parties to an agreement incorporate the complete and final terms of the agreement in a writing, such an 'integration' in fact becomes the complete and final contract between the parties, which may not be contradicted by evidence of purportedly collateral agreements. The point then is, not how the agreement is to be proved, because as a matter of law *the writing is the agreement.* Extrinsic evidence is excluded because it cannot serve to prove what the agreement was, this being determined as a matter of law to be the writing itself." *Alling v. Universal Manufacturing Corp.,* 5 Cal.App.4th 1412, 1433-34 (1992). Thus, the parol evidence rule makes an integrated writing binding on the parties "no mater how persuasive the evidence of additional oral understandings." *Marani v. Jackson,* 183 Cal.App.3d 695, 701 (1986).

B. The "Exception" to the Parol Evidence Rule—Rescission for Fraud in the Inducement

The parol evidence rule does not bar the introduction of evidence of additional oral promises where such evidence is introduced not to vary the terms of the agreement but, rather, to nullify the agreement based on fraud in the inducement. *See* Cal.Civ.Proc.Code §1856(f), (g). Such evidence is not offered to contradict the *terms* of an integrated agreement. Rather, such evidence is offered to show that the purported agreement is null and void. This has come to be known (somewhat imprecisely in the author's opinion) as the fraud "exception" to the parol evidence rule. *See, e.g., Banco Do Brasil v. Latian, Inc.,* 234 Cal.App.3d 973, 1009 (1991).

C. The Exception to the Exception—Rescission Cannot be Based on a Representation that Directly Contradicts an Integrated Written Agreement

Just as there is an exception to every rule, there is also an exception to every exception. (Well, at least there is an exception to this exception.) Put more simply, the fraud exception to the parol evidence rule does not apply where the subspecies of fraud alleged is "promissory fraud" and the alleged false promise is *directly at variance* with the terms of the written agreement. *See Banco Do Brasil,* 234 Cal.App.3d at 1009; *Bank of America Nat'l Trust & Sv. Assoc. v. Pendergrass,* 4 Cal. 2d 258, 263 (1935); *Bank of America Nat'l Trust & Sav. Assoc. v. Lamb Finance Co.,* 179 Cal.App.2d 498, 502 (1960); *Continental Airlines v. McDonnell Douglas Corp.,* 216 Cal.App.3d 388, 419 (1989).

It is not inconceivable that false promises directly at variance with the terms of a contract could actually be made in an effort to induce a party to enter into the contract. This probably does happen. Nor is it inconceivable that one might rely on such promises (notwithstanding contrary language in the contract) in deciding to enter into the contract. This, too, probably happens. Still, under California law, such false promises, *directly at variance* with the terms of the contract, are not actionable.

This rule (the promissory fraud exception to the fraud exception to the parol evidence rule, if you will) is not without its critics. *See, e.g.,* 49 Cal.L.Rev. 877. Limiting the fraud exception to the parol evidence rule so as to bar claims for fraud in the inducement that are based on false promises directly at variance with the terms of a written agreement reflects a policy choice: A decision to favor the policy considerations underlying the parol evidence rule (the stability of written commercial transactions) over those supporting a fraud cause of action. A contrary policy choice might have been equally defensible. That said, it is settled law in California that claims for fraud in the inducement cannot be based on false promises that are *directly at variance* with the terms of an integrated written agreement.

This may seem clear in principle, but it is less clear in application. Let's say that I have just bought Joe Walsh's Maserati and I seek to rescind the purchase and sale agreement based on Walsh's false oral representation that his Maserati does 185 mph. And let's consider four different scenarios:

1. The contract contains no integration clause and is silent as to speed.

This is a clear case: The false promise is not directly at variance with any term of the contract and the contract does not even purport to be the complete expression of our agreement. Under these facts, Walsh's representation that his Maserati does 185 could be the basis of a claim for fraud in the inducement.

2. The contract contains an integration clause and an express representation that the car's maximum speed is 120 mph.

This seems equally clear: The contract is intended as the final expression of our agreement and it addresses the issue of the car's speed. An alleged oral representation that this Maserati does 185 is directly at variance with the terms of the written agreement. Under these facts, Walsh's representation that his Maserati does 185 could not be the basis of a claim for fraud in the inducement.

3. The contract contains an integration clause and a representation that the seller makes no representation as to speed.

Now, arguably, things start to get fuzzy. In one sense, an alleged oral representation that this Maserati does 185 is not directly at variance with a term of the written agreement. That is to say, there is no term in the agreement that says that it *does not* reach this speed. But in another sense, it *is* directly at variance with the written agreement. One could argue that *any* representation as to the car's speed is directly at variance with the term stating that the seller makes *no* representation as to speed. It is not entirely clear how this one would come out, although I am inclined to think that, under these facts, Walsh's representation that his Maserati does 185 could not be the basis of a claim for fraud in the inducement. Any alleged representation as to speed would likely be found to be directly at variance with the parties' contractual provision stating that no representation had been made as to speed.

4. The contract just contains an integration clause.

While there is no one "standard" integration clause, most have the same elements. Assume that this integration clause provides that (i) this written agreement is intended as the final expression of the parties' agreement with respect to the purchase and sale of this car, and (ii) no representations of any kind have been made or relied upon except those representations expressly set forth in this agreement. Provisions such as these are typical in integration clauses. Here, as in the prior scenario, one could argue that any representation as to the car's speed is directly at variance with the term stating that the seller makes no representation of any kind except as expressly set forth in the contract. If, in the prior scenario, it seemed that the oral representation as to speed was directly at variance with an express term of the contract (and, hence, not actionable) one might think that the same reasoning would apply here. But this is where things

get interesting. (Hopefully.)

III. The Exception to the Exception to the Exception—Does the Integration Clause Trump a Claim for Fraudulent Inducement?

Courts in California and throughout the country have grappled with the question of whether a contractual provision stating that no representations or warranties have been made or relied upon except as set forth in the agreement operates to bar all claims for promissory fraud that are based on promises that are not contained in the contract. The results have not been uniform.

In *Fisher v. Pennsylvania Life Company,* 69 Cal.App.3d 506, 510-11 (1977) the Court of Appeal held that such a contractual provision does serve to bar any claim for fraud in the inducement based on any promise that is not contained in the contract. Eighteen years later, another panel held that *Fisher* was wrongly decided and that panel declined to follow *Fisher. Ron Greenspan Volkswagen, Inc., v. Ford Motor Land Dev. Corp.*, 32 Cal.App.4th 985, 990-96 (1995).

The California Supreme Court has not weighed in on this issue and there are no published opinions in California on this issue since *Greenspan*. Prior to *Greenspan*, the Ninth Circuit did cite *Fisher* with approval in *Brae Transportation, Inc. v. Coopers & Lybrand,* 790 F.2d 1439, 1445 (9th Cir. 1986). Witkin, without so much as a passing reference to *Fisher*, states that the rule is as articulated in *Greenspan*. 1 Witkin, Summary of Cal. Law (9th ed. 1990) Contracts, §410, p.368-69 ("A party to a contract who has been guilty of fraud in its inducement cannot absolve himself from the effects of his fraud by any stipulation in the contract, either that no representations have been made, or that any right which might be grounded upon them is waived. Such a stipulation or waiver will be ignored, and parol evidence of misrepresentations will be admitted, for the reason that fraud renders the whole agreement voidable, including the waiver provision").

Jurisdictions holding that an integration clause trumps all claims for fraud in the inducement based on representations not contained in the contract are, decidedly, in the minority. This appears to be the rule in the District of Columbia, see *Hercules & Co., Ltd. v. Shama Restaurant Corp.,* 613 A.2d 916 (D.C. 1992), and, possibly, in Pennsylvania. *See Bardwell v. Willis Co.,* 100 A.2d 102 (Pa. 1953); but *see Betz Laboratories, Inc. v. Hines,* 647 F.2d 402 (3d Cir. 1981) (applying Pennsylvania law). Non-exhaustive research indicates that claims for fraud in the inducement trump the integration clause in Oklahoma, Hawaii, Maine, Alabama, Arizona, and Massachusetts.

IV. Enforceability of Contractual Arbitration Clauses in the Face of Claims for Fraud in the Inducement

So if Witkin is right and fraud renders the whole agreement, including the provision waiving claims for fraud, voidable, what does that mean for arbitration clauses? Put another way, if my contract for the purchase of Joe Walsh's Maserati contains, in addition to an integration clause, an arbitration clause that states "all claims arising out of, relating to, or concerning the validity of this agreement are subject to binding arbitration," do I have to arbitrate my claim for fraudulent inducement? Or is the arbitration clause, like the rest of the agreement void as a result of the fraud?

This would seem to be an easy question. The Code of Civil Procedure provides that arbitration clauses are enforceable unless grounds exist for the revocation of the contract. *See* Cal.Civ.Proc.Code §§1281, 1281.2. And as Justice Mosk explained in *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street,* 35 Cal.3d 312 (1983): "It is one of the essential elements of a contract that the parties enter into it knowingly and consensually, not through fraud, duress, menace, undue influence or mistake. If consent to entering into a contract is obtained by any of the foregoing elements, a court may declare the entire contract to be unenforceable—the entire contract, without exception for any single provision. I can see no reason for selecting one provision of a potentially unenforceable contract, the arbitration clause, and stamping it with our imprimatur." 35 Cal. 3d at 327.

The funny thing is: Mosk's opinion was the dissent! The majority (in a 5-2 decision) held that even when the plaintiff contends that the entire agreement was procured by fraud, the dispute is nevertheless subject to arbitration because, well, because the (potentially void) agreement says so. *See* 35 Cal.3d at 323.

V. I'm Just Looking for Clues at the Scene of the Crime

There may be sound policy reasons why a claim for fraud in the inducement should be subject to arbitration. To be fair, the majority in *Ericksen* does articulate some. But such a rule is certainly hard to square with a blanket proclamation that fraud renders the entire agreement voidable. That is, it is difficult to understand why I can bring a claim for fraud in the inducement, notwithstanding a contractual provision waiving such claims, but I cannot bring that claim in a court of law in the face of contractual provision (in a contract that may be void) waiving the right to go to court.

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