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Mum's The Word: Why Saying Too Much May Invalidate A Contract

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Business contracts are the sowing ground of many future disputes. All too often, management enters into contracts without seeking qualified legal counsel or the contract parameters are not fully understood or communicated, and to make matters worse, oral promises are sometimes inferred. A recent California case has made the difficulty of contract law more apparent and is worth reviewing so that companies can minimize litigation arising from contracts.

Impact of Recent Overturned Case

A bedrock principle of contract law is that parties who enter into written contracts have the right to (a) rely on the expressed contract terms to obtain the contract's benefits, (b) carryout the contract's obligations, and (c) determine the outcome of disputes relating to contract enforcement. Law being law, however, there are exceptions to this rule, as well as exceptions to the exceptions, which as clear as they may be, are subject to the often divergent views of judges and arbitrators. For business owners, the importance of this situation is that not only should they engage legal counsel when entering into or disputing contracts but also their lawyers should keep abreast of recent court decisions so that they can prepare for litigation and anticipate the outcome.

The defender of this bedrock principle is the "parol evidence rule," the gist of which is that contracting parties may not introduce evidence of oral promises (i.e., "parol evidence") made before or contemporaneously with the execution of a written contract for purposes of altering or adding terms to the written contract when the contract is deemed a final expression of the parties. Based on this longstanding principle, California courts have consistently held that "when a person with the capacity of reading and understanding an instrument signs it, he [or she] is, in the absence of fraud and imposition, bound by its contents, and is … [prohibited] from saying that its provisions are contrary to his [or her] intentions or understanding." In other words, parties are responsible for reading and understanding the contracts they sign.

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That may seem relatively straightforward but again, law being law, it isn't that simple. Given that fraud is an exception to the parol evidence rule, attorneys will often plead fraud in complaints even when disputes involve the enforcement of written contracts. Attorneys do this so the court may consider evidence that would not otherwise be admissible, in the hopes of voiding the contract or as a mechanism to survive summary judgment. To curb this litigation tactic, back in 1935 the Supreme Court in Bank of America v. Pendergrass, ruled that parol evidence "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." Since then, this limitation on the fraud exception to the parol evidence rule has been the law in California. That is, until now.

In January 2013, the Supreme Court overruled Pendergrass in Riverisland by holding, in part, that the Pendergrass rule was "inconsistent with the governing [parol evidence] statute."

Later, the Supreme Court affirmed by additionally holding that, "Parol 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." "When fraud is proven, it cannot be maintained that the parties freely entered into an agreement reflecting a meeting of the minds", which is required to establish the existence of a contract. For these reasons, the Pendergrass rule is no more.

Key Applications for Management

The moral of this story is that the courts are, for better or worse, severely weakening the parol evidence rule and parties to a contract can no longer rely solely on the terms of a written instrument. Anything a contracting party says before or contemporaneously with the execution of a contract can and will be used against said party in a court of law, especially if the statements mischaracterize the contents or erroneously explain the meaning and effect of a provision in a written document.

Accordingly, in today's fast-paced economic climate, parties to a contract should take great care with statements made before or concurrently with the execution of a contract. For example:

- Emails and correspondence should be minimal.

- A party to a contract should not make representations regarding the contents of a contract or the meaning of a provision contained within a contract, unless that party has a fiduciary duty to do so, nor should a party to a contract make a promise that contradicts a provision of a contract. This includes sales representatives, as they are agents of the contracting party.

- If a party to a contract asks what a provision means, now, unfortunately, one should advise the inquiring party to read the contract or take the contract to have it reviewed by an attorney.

This approach is not conducive to smooth or efficient negotiations, but given the expanding application of Riverisland, few options remain.

Furthermore, contracts should contain provisions that no party to the contract has made a promise or representation to the other before or contemporaneously with the execution of the contract, and that the parties have given each other the opportunity to review the contract and understand the contents and terms therein on their own.

Finally, while the thought of more paperwork is not appealing, prudent counsel will require contracting parties to sign a separate one-page document or declaration that states the same, and references the contract and the parties thereto.

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