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Lender Alert

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California Supreme Court Eliminates Lender Defense to Borrower Fraud Claims

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On January 14, the California Supreme Court issued its opinion in *Riverisland Cold Storage v. Fresno-Madera Production Credit Assn*., which takes away a lender defense to borrower fraud claims and will therefore have a significant impact on all California lenders.

In *Riverisland,* commercial borrowers sued a lender over a forbearance agreement. The borrowers claimed that the workout officer orally promised them that the bank would extend the loan for two years in exchange for two additional properties as collateral. The integrated forbearance agreement, which the borrowers admitted they did not read, provided for a three-month forbearance and eight additional properties as collateral. Notably, the borrowers had initialed most of the pages referencing the eight properties, indicating that they had an opportunity to read those pages, but the Supreme Court did not find this persuasive on the legal issue it decided. In the borrowers' suit for fraud, the trial court granted summary judgment for the lender and excluded the borrowers' parol evidence of the alleged pre-agreement promises, because they directly contradicted the forbearance agreement terms. The Court of Appeal reversed. The Supreme Court unanimously *affirmed* the reversal, overruling the trial court and California law in effect for more than 75 years.

In its *Riverisland* decision, the Supreme Court expressly rejected its own 1935 decision in *Bank of America v. Pendergrass*, which held that parol evidence is not admissible to prove a promise "directly at variance with the promise of the writing.For decades, lenders have relied on *Pendergrass* to dismiss borrower fraud claims alleging misrepresentations (oral and written) by loan officers that differ from the final written agreement of the parties*. That defense is apparently no longer available to lenders or any contracting party in California in the face of a claim that the party challenging the written contract was defrauded into signing it by promises of a deal different from the written agreement.*

To put this in perspective with an example, many lenders will recall that, in the 1980s, farm values skyrocketed as suburban construction spread closer to farmland and open space. As a result, appraisers valued farms at multiples of their previous value, and farmers were able to borrow against their "equity" at adjustable rates to meet their seasonal expenses. In hindsight, many over-borrowed.

When interest rates climbed to double digits and prime approached 20 percent, many farmers defaulted and responded with fraud claims alleging oral lender promises supported by no documentary proof. Central valley juries responded with $40MM+ verdicts for farmers, and banks stopped lending for a while, freezing capital needed by many borrowers including farmers. Eventually, the courts and the Legislature realized that this was no way to allocate bank resources. The California appellate courts responded, rejecting such fraud claims based on *Pendergrass*, as well as other untenable claims such as that banks were "quasi fiduciaries" of their borrowers. The Legislature also amended the statute of frauds to bar loan claims without a writing, if the commercial loan amount exceeds $100,000. The tide of oral fraud claims against commercial lenders was stemmed for nearly three decades—until now.

After *Riverisland*, Consumers' counsel will be pleased to add a new fraud "arrow" to their quiver, and lenders should expect such fraud claims to be raised with every loan in default. On the somewhat positive side for lenders, the Supreme Court did hold that borrowers must still prove each of the elements of fraud, but they will likely get the chance to do so at trial. The Supreme Court indicated that justifiable borrower reliance *might* be negated by an admission that the plaintiff did not read the agreement when (s)he signed it.

Some commentators believe that *Riverisland* was properly decided. Others contend that it will remedy a perceived problem in the banking industry, which results when a borrower is given a stack of loan documents at closing with no opportunity to determine whether loan terms differ from prior lender promises. For the immediate future, we recommend the following:

1. If juries may, once again, have the task of allocating bank resources to allegedly defrauded borrowers, lenders should include arbitration or judicial reference clauses in their loan agreements. One risk of a fraud claim is that, if

proved, it would render the entire agreement invalid, because the parties did not have a "meeting of the minds" on essential terms. That would call into question other agreement terms, including the alternative dispute resolution provisions. However, we still recommend such clauses, which put resolution of the borrower's fraud claim in the hands of an arbitrator or judge, not an impassioned California jury.

2. In addition, lenders should consider providing loan documents to the borrower a few days in advance of closing, so that the borrower (or his/her counsel) has an opportunity to read them, perhaps with a clause encouraging the borrower to have independent counsel assist in the borrower's review. A legend on the loan documents or transmittal information initialed by the borrower could establish the fact of early delivery. Having the borrower initial each page of the agreement(s) may also be helpful to argue that the borrower read the terms and did not complain (but, note, that the borrowers in *Riverisland* initialed loan documents identifying the eight properties, and that did not change the Court's ruling).

It is worth noting that none of the foregoing approaches provides a *Pendergrass*-style absolute defense to a fraud claim. Rather, they provide evidence that the borrower's claim of an inconsistent promise is not credible and/or that the borrower did not rely on the alleged promise. Thus, they are worth considering now, before the next fraud claim hits your desk.

The firm will continue to send updates as more information becomes available.

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