

Using Non-Reliance Clauses in Defense of Fraud Claims

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Imagine a lawsuit is brought against a client of yours, perhaps a realtor or other salesperson. Picture that this lawsuit arises out of your client's sale of a house, a gross of widgets, whatever, to the plaintiff, who bought this product and began using it. Imagine that the product was completely defective and was slowly draining the plaintiff of funds. As a result, in his or her lawsuit the plaintiff has alleged the worst lies, cheats, and acts of fraud committed by your client. Pretend that your client denies telling any of those alleged lies, and truthfully insists he or she did not commit fraud. Better yet, imagine that he or she has documents, audiotapes of every conversation with the plaintiff, and other ironclad proof to defeat the plaintiff's allegations.

Unfortunately, we as commercial trial attorneys do not live in the world of our imagination. While the first part of the preceding paragraph is all too familiar a scenario to us, rarely do we have a client who can refute allegations of fraud with tangible proof. Most of the time, our clients only have, if they are lucky, a written contract. More unfortunately, it is too late for these clients to stop the litigation without full blown discovery and a trial or expensive settlement payment. How, then, can an innocent salesperson protect himself or herself from baseless allegations?

The answer may rest in the contract itself. A small but burgeoning number of jurisdictions have been analyzing and, in some cases, are beginning to analyze allegations of fraud in the inducement in the context of the contract's language. These jurisdictions are holding that certain contractual language can bar, as a matter of law, fraud in the inducement claims. This article will attempt to highlight the rationale behind these holdings and provide some guidance to direct commercial clients to draft stronger contracts in defense of future claims of fraud.

Caveat Sellers

Contracts often contain integration, merger or non-reliance clauses (also called no-reliance clauses), or all three. The first two types of clauses generally consist of a recital that the writing contains the entire agreement between the parties, that all prior negotiations and agreements are merged in that agreement, and that all additions to or alterations or changes in the contract must be in writing and signed by both parties. Non-reliance clauses, on the other hand, are paragraphs which state that the parties have not relied upon oral representations in entering into or executing the subject contracts. All three clauses announce and demonstrate the all-inclusive nature of the written instrument and furnish an additional

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reason for applying the parol evidence rule, which in general precludes all prior or contemporaneous statements contradicting the terms of the written agreement. *See 29A Am. Jur. 2d Evidence § 1095; see also Williston on Contracts § 33:21. Effect of merger clause in written contract.* More often than not, however, these clauses are boilerplate provisions included in most contracts, but not negotiated by either party. In part because of their boilerplate nature, it appears that courts often ignore integration and merger clauses in fraud claims.

In the majority of jurisdictions, an integration clause is considered ineffective to bar parol evidence of fraudulent misrepresentations as to the terms or substance of the agreement. As these courts rationalize, fraud is a tort, and the parol evidence rule is not a doctrine of tort law; thus, an integration clause does not bar a claim of fraud based on statements not contained in the contract. *See, e.g., Vigortone AG Products, Inc. v. PM AG Products, Inc., 316 F.3d 641 (7th Cir 2002).* In *Vigortone*, the Seventh Circuit, applying Illinois law, ruled that the integration clause at issue did not bar evidence of misrepresentations that induced the plaintiff to purchase the defendant's business. In explaining its rationale, the Seventh Circuit stated

all an integration clause does is limit the evidence available to the parties should a dispute arise over the meaning of the contract. It has nothing to do with whether the contract was induced, or its price jacked up, by fraud. *Id.* at 644.

Georgia law, for example, holds likewise. *See, e.g., Potomac Leasing Co. v. Thrasher, 354 S.E.2d 210 (Ga.App.1987).* In *Potomac Leasing*, the defendant asserted fraud in the inducement as a defense to breach of contract claim. The Georgia Court of Appeals explained that a contractual defense of fraud in the inducement by oral misrepresentation is the functional equivalent of a tort action for fraud and deceit, so that the merger clause in the agreement would not prevent the defendant from proving that oral misrepresentation induced his entry into the agreement. Apparently believing that the rule needs no explanation, the Court simply stated:

The rule that parol agreements shall not be received to change or add to the terms of a written contract does not apply where the alleged contract was procured by fraud. A stipulation in a contract that the provisions thereof constitute the sole and entire agreement between the parties and that no modification thereof shall be binding on either party unless in writing and signed by the seller can have no bearing in a case where fraud to induce the contract is the issue. *Id.*, 354 S.E.2d at 213-214.

Illinois and Georgia law demonstrate the general rule that integration clauses do not bar fraud claims because integration clauses are not addressed to such tort claims. At the same time, these cases are illustrative of the longtime rule such that the Courts have stopped explaining the rationale behind the rule.

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As such, the general rule seems to be overly harsh in the majority of claims where the alleged fraud goes to the heart of the agreement between the parties. In such circumstances, integration clauses should be given more weight than that given by Georgia, Illinois and their fellow jurisdictions.

The Winds of Change

Even though a majority of jurisdictions state that general integration and merger clauses cannot be used as a defense to tort claims, some jurisdictions such as South Carolina are moving to a more modern rule in using contractual clauses in defense to fraud claims. See e.g., *Slack v. James*, 364 S.C. 609, 614 S.E.2d 636 (2005). In *Slack*, the South Carolina Supreme Court considered whether the parties' integration clause prevented the Buyers from suing the Sellers for misrepresentations regarding an easement on the Sellers' home. The real estate contract stipulated:

This written instrument expresses the entire agreement, and all promises, covenants, and warranties between the Buyer and Seller. ... Both Buyer and Seller hereby acknowledge that they have not received or relied upon any statements or representations by either Broker or their agents which are not expressly stipulated herein.

In result, the South Carolina Supreme Court followed the general rule that integration clauses are not defenses to fraud claims. The Court plainly stated "[n]either the parol evidence rule nor a merger clause in a contract prevents one from proceeding on tort theories of negligent misrepresentation and fraud." *Id.* at 616, 614 S.E.2d at 640. However, the Court also intimated that some contract clauses could act as a bar to such tort theories. "A *general* non-reliance clause, just as a merger clause, does not prevent one from proceeding on tort theories of negligent misrepresentation and fraud." *Id.* at 618, 614 S.E.2d at 641 (emphasis added). Unlike the Illinois and Georgia decisions, the South Carolina court based its reasoning on the simple, but elegant premise that "[a] party should not be given the opportunity to free himself from an allegation of fraud by incorporating a *generalized* non-reliance clause into a contract." *Id.* (emphasis added).

While the Court did not explain what type of clause would pass muster, it ruled against the instant clause because it lacked "the required specificity." *Id.* Therefore, the commercial clients in South Carolina at least may breathe a sigh of relief that the winds of change are coming to the Palmetto State. It appears that South Carolina will soon accept specific non-reliance clauses in defense of fraud claims, much like some other jurisdictions currently do.

Reasonable, Negotiated Expectations

While in general, integration clauses are not a bar to fraud claims, non-reliance clauses are on the rise in

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negotiated contractual settings. For instance, the Seventh Circuit has approved their use in securities cases to preclude allegations of fraudulent misrepresentations. See, *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000). In *Rissman*, the United States Court of Appeals for the Seventh Circuit, this time applying federal securities law, held that a non-reliance clause in a stock purchase agreement “preclude[s] any possibility of damages ... for prior oral statements.” *Id.* at 383. Again, the rationale is elegant, but simple:

A non-reliance clause is not identical to a truthful disclosure, but it has a similar function: it ensures that both the transaction and any subsequent litigation proceed on the basis of the parties’ writings, which are less subject to the vagaries of memory and the risks of fabrication.

...

Prudent people protect themselves against the limitations of memory (and the temptation to shade the truth) by limiting their dealings to those memorialized in writing, and promoting the primacy of the written word is a principal function of the federal securities laws. *Id.* at 384.

Likewise, under New York law, parties may use specific non-reliance clauses in contracts to defend fraud claims. New York law differentiates between general non-reliance clauses (which do not bar fraud claims), and specific non-reliance clauses (which do bar fraud claims). In *Stanley v. Bray Terminals, Inc.*, 197 F.R.D. 224 (N.D.N.Y. 2000), the United States District Court considered a fraud claim brought by the defendant against the plaintiff where the plaintiff misrepresented that it could ship sufficient amounts of goods to the defendant. Stating the general rule of New York law the district court explained that “when a party alleges it was fraudulently induced to enter into an agreement that contains specific language disclaiming reliance on any oral representations, the parol evidence rule will bar a showing of fraud either in the inducement or in the execution of the agreement.” *Id.* at 228. The Court explained that a different rule would allow a party to unfairly “claim fraudulent inducement after it plainly and deliberately announces that it is not relying on these representations...” *Id.* A contrary rule would allow the party to “benefit from its own deliberate misrepresentation when placing its signature on a specific merger clause.” *Id.* Even so, the District Court went on to find the non-reliance clause was not specific enough to preclude the Defendant’s counterclaims for fraud as a matter of law. *Id.*

As the *Rissman* and *Stanley* courts reasoned, recognizing non-reliance clauses as a bar to fraud claims furthers contractual freedom and evidentiary purposes; specifically, it allows parties to contract to not rely on memories of oral agreements which tend to fade over time. *Rissman*, 213 F.3d at 284. Furthermore, it prevents parties from undermining the negotiation process by deliberately misstating they are not relying on oral representations and then later sue for fraud based on oral representations. *Stanley*, 197 F.R.D. at 228.

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Building the Better Mouse Clause

To avoid the harshness of the general rule on integration clauses, but at the same time satisfy the specificity requirements of *Rissman*, *Slack* and *Stanley*, commercial parties should draft specific non-reliance clauses separate from the general integration or merger clauses in the contract. Under this more modern view on non-reliance clauses, commercial clients should include the most significant oral representations in non-reliance clauses to avoid a later lawsuit. For instance, in a real estate sales contract like *Slack*, the parties could agree that the buyer has not relied on representations as to the easements or other matters as to title. To avoid a similar result as in *Stanley*, the parties could agree that the defendant did not rely on representations related to the amount of the plaintiff's use of the defendant's storage facilities. In sum, if the sophisticated commercial client wishes to avoid litigation on a given set of facts, it should include those facts as oral representations upon which the putative plaintiff did not rely.

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