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Seventh Circuit Permits Parol Evidence to Prove Fraud in the Inducement Despite Lack of Fraud in Integration Clause

Earlier this week the Seventh Circuit Court of Appeals handed down a remarkable decision shedding great insight into the use of parol evidence to prove fraud in the inducement. After thorough examination, the court determined that the trial court had incorrectly concluded that Indiana law mandated that parol evidence could only be used to prove fraud in the inducement where there was fraud related to the formation of the integration clause. On appeal, the Seventh Circuit held that "the mere presence of an integration clause does not preclude . . . introduc[tion of] parol evidence that it was fraudulently induced to enter into the" contract as a whole

If you have survived the first paragraph of this post, bear with me and let me unpack what I just said. I am quite aware how thick with lawyerspeak that opening paragraph was. In order to not alienate half of my readers, I am going to provide a simplified statement of what I just said, and then I will proceed to explain the legal implications and the complexities of what this all means. Put simply, the court

decided that evidence of more than just what a contract says on paper may be used to prove that a person only signed a contract because of the fraud committed by the other party to the contract. You are probably wondering why I didn't just say that to begin with. The reason is because it is much more nuanced than my simplified translation, but that is the thumbnail sketch of what the case means. If you are a lawyer who feels comfortable with these terms, then skip the next section and jump to the discussion of the case.

I. Fraud in the Inducement, Parol Evidence, & Integration Clauses 101

Before we delve into this specific case – *Judson Atkinson Candies, Inc. v. Kenray Associates, Inc.* – we need to get on the same page with some of the important terms. The first is "fraud in the inducement." This is a legal term of art that is a defense to enforcement of a contract. There are two basic forms of fraud that can be used to resist the enforcement of a contract. The other form is "fraud in the execution." Though the names may not make it seem so, in reality these two concepts are pretty easy to understand. Fraud in the execution is where one party fraudulently convinces the other party to sign a contract that does not actually say what the signing party thought it said. A good example of this is if you agreed to sell your car to someone for $5,000 and when the other person draws up the contract he writes the sale price as $4,000 then has you sign the contract telling you that it says $5,000. If you could show this type of fraud, then you would not be bound to the contract you just signed and would not have to sell your car for only $4,000.

Fraud in the inducement is similarly straightforward. It is where a person fraudulently misrepresents specific circumstances. Relying upon these misrepresentations, someone agrees to enter into a contract. The marquee difference is that in fraud in the inducement, the person trying to avoid enforcement of the contract does not argue that he did not know one of the terms or that a term of the contract was wrong. The person argues that because of the fraud, he agreed to the terms that were actually written.

The second term you have to understand is "parol evidence." Ladies and gentlemen, those of you who are not attorneys may find some comfort in the fact that the phrase "parol evidence" bamboozles many a lawyer. I am going to provide a very brief discussion of parol evidence here. If you want a more thorough discussion, I direct you to my post from this past November entitled *Contract Interpretation & The Parol Evidence Rule*. Prepare for what seems like a tautology, parol evidence is the type of evidence barred by the parol evidence rule. The parol evidence rule is a rule of contract law that says parol evidence cannot be considered in interpreting a contract. The parol evidence is evidence that comes from a source other than the written contract. Now the parol evidence rule is not an absolute bar to any evidence

that is not the specific language on the paper, but it is the starting point that must be gotten around.

As I outlined in my prior discussion on parol evidence, the obstacles to overcoming the parol evidence rule get harder and harder to overcome if the contract is unambiguous and includes an "integration clause." An integration clause is our third and final important phrase before we dive into the case. An integration clause is a statement in a contract that says that all of the terms of the parties' agreement are written in the paper contract and rejects any other terms. Traditionally, if there is an integration clause in an unambiguous contract, then no evidence outside of the terms written on the paper can be mentioned to the judge or the jury. The fact that this case goes against that last sentence is why it is important. To the case we go!

II. *Judson Atkinson Candies, Inc. v. Kenray Associates, Inc.*

This case was the product of a failed settlement agreement between Atkinson Candies and Kenray Associates. Atkinson Candies had sued Kenray Associates. While the case was pending, Kenray agreed to settle the case. The terms of the settlement required Kenray to agree to entry of judgment against it with Atkinson agreeing not to "execute" that judgment – meaning to not try to get money directly from Kenray. Atkinson agreed to this settlement in exchange for Kenray's legal rights either to insurance coverage – the issue of whether insurance coverage applied was being decided in a different case – or the right to sue Kenray's insurance agent.

Kenray's lawsuit against its insurance company was unsuccessful. Atkinson, using Kenray's legal rights, sued the insurance agent and lost. This left Atkinson with a settlement agreement and no money whatsoever. Atkinson sought to have the settlement agreement – a contract – found unenforceable so as to allow Atkinson to execute its judgment against Kenray and try to get some money from the case. In order to try and do so, Atkinson claimed that Kenray had lied to Atkinson to acquire the settlement agreement. Specifically, Atkinson claims that Kenray fraudulently informed Atkinson that Kenray's "insurance agent had confirmed that Kenray had insurance coverage[.]" Were that representation true, there would be no fraud. However, Atkinson argued that Kenray knew "that, in fact, the insurance agent had advised Kenray that Hoosier would likely deny the claim, and that Kenray intentionally withheld this information from Atkinson." There is the crux of the fraud in the inducement.

The parol evidence dilemma arises because there was an integration clause in the settlement agreement. The trial judge, looking to a less than crystal clear

web of Indiana cases on the issue, concluded that the only way that parol evidence could be used to prove fraud in the inducement is if the evidence of fraud shows that the integration clause itself was only agreed to because of fraud. First, let me note that outside of using parol evidence I do not know how anyone would propose to prove fraud in the inducement. I cannot imagine a written contract having terms in it that are on their face sufficiently fraudulent to prove it without parol evidence. Second, it would be the most rare of circumstances in which a person could actually show that the only reason that he agreed to the integration clause was because of fraud. I can at least envision scenarios in which that could occur, but they would be very much the exception.

On appeal, the Seventh Circuit looked to Indiana caselaw and found that in deciphering an integration clause, a court must use the same guiding principle as other contractual provisions: "determine the intention of the parties and to determine if that which they intended to contract to is fully expressed in the four corners of the writing."

> Because an integration clause "is only some evidence of the parties' intentions," the court "should consider an integration clause along with all other relevant evidence on the question of integration." As such, the mere inclusion of an integration clause "does not control the question of whether a writing is or was intended to be a completely integrated agreement." In the end, "the weight to be accorded an integration clause will vary, depending on the facts and circumstances of each particular case." And the court is "to hear all relevant evidence, parol or written" in making this determination.

With that principle in mind, the court set out to determine:

> where a party to a contract alleges fraudulent inducement and the contract in question has a valid integration clause, must the party demonstrate that it was fraudulently induced to agree to the integration clause itself before it can rely upon prior representations to vitiate the contract, or is it sufficient for a party to show that it was fraudulently induced to enter into the contract as a whole? . . . [T]he district court found that, before Atkinson could invoke any parol evidence, it had to show that it had been fraudulently induced to agree to the integration clause it- self. Because we believe that this is too narrow a reading of Indiana law, we reverse.

While on first blush, the concept that one may still be bound to a part of a contract that was itself procured by fraud may seem downright batty. I do not

disagree. However, there is at least one area of law where that kind of lunacy does exist. There was a recent Florida Supreme Court case that found an arbitration clause in a contract enforceable to the determination of whether the contract that was being challenged was the product of fraud in the inducement. Thus, while it may seem absurd and anti-commonsensical, Magistrate Judge Hussman was not off his rocker to think that Indiana law would require such a finding. Indeed, given that Magistrate Judge Hussman is one of the finest jurists in the land, it would be foolhardy to think he came to his conclusion lightly.

The Seventh Circuit, with District Judge John Z. Lee sitting by designation and authoring the opinion, examined a great deal of Indiana cases having dealt with integration clauses. After the examination of mostly intermediate court decisions and a handful of Indiana Supreme Court decisions, the court's inescapable conclusion was that the imposition of an inflexible rule, as had been found by Magistrate Judge Hussman, "would unreasonably restrict the trial court's ability to conduct the factual analysis that" Indiana law requires. Some of the factors to the analysis are "the existence of no-reliance or disclaimer language, as well as the relative sophistication of the parties and the circumstances surrounding the agreement's execution."

Due to this need to be flexible, the Seventh Circuit concluded that Atkinson should be permitted to produce parol evidence to attempt to prove that it had entered into the settlement agreement **as a whole** based upon fraud.

For my two cents, I am very happy with the Seventh Circuit's decision in as much as it avoids what I think would be an absurd result. That said, I am not exactly sure that the Seventh Circuit's reasoning is truly sound. Nor am I convinced that Magistrate Judge Hussman's conclusion was correct either. It seemed that the rub lies somewhere in between. I believe the missed step was the errant assumption that an integration clause is an integration clause is an integration clause. Note in one of the above indented quotes, the citation uses the phrase "completely integrated." I discussed this concept much more fully in my prior parol evidence post, but put simply there are varying degrees of integration of a contract. True, generally an integration clause is treated as "completely integrating" – as opposed to partial integration – a contract. However, I think the middle ground is that parol evidence can be used to establish whether the integration clause is sufficient to completely integrate the contract.

While I think that the more fair verdict based upon the Seventh Circuit's analysis is what I just outlined, I most certainly do not think that such a result is what the dictates of justice mandate. The thought of applying such a peculiar standard – *id est* requiring a challenge to an integration clause prior to challenging

the whole contract for fraud – fills with me with the mental image of every Themis statue gracing a judicial bench removing her blindfold to reveal the incredulous eyes of a mother who just had to listen to the wildest explanation from her child of how he got grass stains on his brand new pants.

I invite you to read both decisions and decide for yourself what you think the merits of my two cents are worth. For those of you reading on the Hoosier Litigation Blog, the links are provided. For those of you reading on JD Supra, the citations are below along with the URL for the trial court decision. The Seventh Circuit decision is easily found with a Google™ search. As for my opinion, it goes without saying that since no one calls me "your honor," my opinion can be taken *cum grano salis*, or, to borrow and appropriate a passage from the immortal bard:

> I charge you, O women, for the love
> you bear to men, to like as much of this [post] as
> please you: and I charge you, O men, for the love
> you bear to women--as I perceive by your simpering,
> none of you hates them--that between you and the
> women the [post] may please.

As You Like It: Epilogue, lines 12-17.

Join us again next time for further discussion of developments in the law.

Sources

- *Judson Atkinson Candies, Inc. v. Kenray Assocs., Inc.*, ___ F.3d ___, Nos. 12-1035 & 12-1036, 2013 WL 2505814 (7th Cir. June 11, 2013).

- *Atkinson Candy Co. v. Kenray Assocs., Inc.*, No. 4:02-CV-242-WGH-SEB, 2011 WL 2607069 (S.D. Ind. June 29, 2011), *rev'd sub nom. Judson Atkinson Candies, Inc. v. Kenray Assocs., Inc.*, ___ F.3d ___, Nos. 12-1035 & 12-1036, 2013 WL 2505814 (7th Cir. June 11, 2013): available at http://docs.justia.com/cases/federal/district-courts/indiana/insdce/4:2003cv00012/1588/151/.

- *Jackson v. The Shakespeare Foundation: Arbitration Clauses Are Not as Far From Fraud as Heaven from Earth*, The Florida Supreme Court Blog (Feb. 13, 2013). ←In case you were wondering why I had Shakespeare on the mind.

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