Archetype IP℠

Food For Thought

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"Show me what the parties did . . ."

Twice I have started new in-house roles and inherited contract disputes that, to my dismay, were doomed by the "course of performance" rule for contract interpretation. Because this rule and its persuasive power appear to not be widely known or well-understood,[i] course of performance is a worthy topic for a Food for Thought.

The meaning and power of course of performance is well summed up by "an old saying of an English judge: 'show me what the parties did under the contract and I will show you what the contract means.'" [ii]

The Restatement defines course of performance and its effect as follows: "Where an agreement involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection is given great weight in the interpretation of the agreement." [iii]

The Uniform Commercial Code ("UCC") also provides a definition: "A 'course of performance' is a sequence of conduct between the parties to a particular transaction that exists if: (1) the agreement of the parties with respect to the transaction involves repeated occasions for performance by a party; and (2) the other party, with knowledge of the nature of the performance and opportunity for objection to it, accepts the performance or acquiesces in it without objection." [iv] The UCC further explains that course of performance "is relevant in ascertaining the meaning of the parties' agreement, may give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of the agreement." [v]

I. "Course of Performance" as Strong Evidence of Original Contract Meaning

The first case I inherited was a confidential arbitration, so I cannot use the facts and outcome of that case as an illustrative example, but the second was a district court litigation in which summary judgment was granted. That case and its summary judgment order provide a useful illustration of the power of course of performance evidence in interpreting the meaning and scope of a contract.

In 1997, Agilent Technologies entered into a patent license with Perkin Elmer under which Agilent would pay royalties for a particular type of mass spectrometry instrument to the extent the instrument "is used for the production or analysis of multiply charged ions" in a manner that would, but for the license, infringe one of Perkin Elmer's patents. [vi]

From 1997 to 2009, Agilent paid royalties on mass spectrometry instruments that were *capable of* the production or analysis of multiply charged ions rather than on instruments that *actually did* produce or analyze such ions. In 2009 Agilent *revised* its interpretation of the contract, deciding that the contract only required payment of royalties on instruments that were "actually . . . used for the production or analysis of multiply charged ions." [vii] However, "Agilent did not alert PerkinElmer of that change but continued to pay royalties based on its 'correct' understanding." [viii] Perkin Elmer was unaware of Agilent's unilateral correction of its royalty obligation until 2011, when Perkin Elmer sued Agilent for breach of contract and patent infringement. [ix]

It was in 2014, just after summary judgment briefing, that I inherited this case. In granting summary judgment to Perkin Elmer on the royalty issue the court discussed the negotiation leading up to the 1997

license, noting that "the parties faced a dilemma: either measure the actual use of Agilent's customers in order to determine infringement or adopt a compromise to obviate the need to make such measurements." [x] Because "determining how an end user operates the subject instruments was, and remains, practically impossible absent an onerous (and expensive) monitoring system," in the court's view the parties compromised in the license such that "all instruments *capable of* infringing would be assumed to infringe." [xi]

Supporting its decision that the contract language was "abundantly clear," the court cited the parties' course of performance:

> Here, the fact that the parties to the agreement at issue interpreted it as indicating only potential use for the first 12 years of the its existence is decisive. If "there is no surer way to find out the intent of the parties than to see what they have done," *New York Marine & Gen. Ins. Co. v. Lafarge North America, Inc.*, 599 F.3d 102, 119 (2d Cir. 2010), then a dozen years of conduct is surely all but conclusive. [xii]

Although the court said that it relied on course of performance in supporting its determination that the contract was itself abundantly clear, the course of performance evidence – Agilent having paid royalties for 12 years on instruments merely *capable of* infringing – was likely the true underlying reason for the decision. [xiii] For example, the literal contract language was at least arguably ambiguous by use of the phrase "is used for" rather than "is capable of" while Agilent's course of performance was clear.[xiv]

I settled this case about a month or so after the summary judgment decision.

II. "Course of Performance" Modifying the Terms of Contract.

Course of performance has also been relied upon to *modify* the express terms of a contract. To me this represents a significant expansion of the course of performance rule because, rather than establishing the original intent and understanding of the parties, modifying the contract gives effect to a new, after-arising intent and understanding of the parties. Using course of performance to modify a contract can make sense, however, if it is considered akin to an oral modification or as an implied contract to modify an existing one.

The Restatement acknowledges the possibility of using course of performance to modify a contract, [xv] and the UCC expressly provides that, subject to certain limitations, "a course of performance is relevant to show a waiver or modification of any term inconsistent with the course of performance." [xvi]

California, New York, and Illinois all recognize the possibility of modifying a contract by course of performance,[xvii] as do other states. As an example, *Davidson v. Cao,* [xviii] involved a confidential disclosure agreement ("CDA") that required confidential information disclosed thereunder to be marked "confidential." The parties did not comply with that obligation, however, and the issue was not what the original CDA meant but rather whether the CDA had been modified by the parties' subsequent conduct such that public disclosure by the receiving party of an unmarked document was a breach of the CDA. The published decision arose from a motion to dismiss for failure to state a claim, and the magistrate recommended that the breach of contract claim not be dismissed because the parties' conduct "support[ed] recovery under the actionable theory that the parties modified the 1998 CDA by mutually accepting and exchanging documents without stamped markings and treating such documents as confidential and subject to the 1998 CDA." [xix] The magistrate explained that under Illinois law, a "contract is validly modified if the party which did not propose the changes is shown to acquiesce in the modification through a course of conduct." [xx]

[i] In each of the cases that I inherited, prior awareness of the rule, its applicability, or its strong persuasive effect was unclear. The disputes might have well have ended up as full-blown proceedings because the other side had studied the law, understood how the course of performance rule applied, and more accurately gauged the strength of its case.

[ii] *Thompson v. Fairleigh,* 300 Ky. 144, 187 S.W.2d 812 (1945).

[iii] Restatement, 2d, Contracts § 202. Here is an example of the use of course of performance from the Restatement:

> A discloses to B a secret formula for an antiseptic liquid and B agrees to pay monthly royalties based on amounts sold. Fifty years later the formula has been published in medical journals. After continuing to pay for another 25 years, B contends that the duty to pay royalties ended when the formula ceased to be secret. B's conduct strongly negates the contention.
>
> *Id.*

[iv] UCC § 1-303(a); *see also* UCC § 2-208(1) (Course of Performance or Practical Construction).

[v] UCC § 1-303(d); *see also* UCC § 2-208(3) (Course of Performance or Practical Construction).

[vi] The facts are drawn from the September 24, 2014 Memorandum & Order in D-Mass Case No. 1:12-cv-10562 (herein "Memorandum & Order").

[vii] Memorandum & Order at 19.

[viii] *Id.*

[ix] *Id.*

[x] *Id.* at 21.

[xi] *Id.*

[xii] *Id.*

[xiii] Agilent's unilateral, uncommunicated re-interpretation of the agreement also likely weighed heavily in the decision to the extent that (i) the court viewed it as indicative of Agilent's state of mind vis-a-vis the original, correct contract meaning; or (ii) it precluded Perkin Elmer from either objecting or acquiescing to Agilent's revised contract interpretation, thereby preventing the three years of payments (2009-11) by Agilent that were limited to instruments that actually did produce or analyze multiply charged ions from becoming course of performance for either original contract interpretation or modification of the original contract.

The Restatement requires that the other party have "knowledge of the nature of the performance and opportunity for objection to it" and, in a comment, explains that "self-serving conduct is not entitled to weight." Restatement, 2d, Contracts § 202, comment g. The UCC similarly frowns on unilateral, uncommunicated re-interpretations of agreements, requiring instead that "the other party, with knowledge of the nature of the performance and opportunity for objection to it, accepts the performance or acquiesces in it without objection." UCC § 1-303(a).

[xiv] Although the court did state that "*the parties* to the agreement at issue interpreted it as indicating only potential use for the first 12 years of the its existence," it did not expressly discuss Perkin Elmer's knowledge of or acquiescence in Agilent's 12 years of payments on all instruments capable of producing multiply charged ions. There are three likely explanations: (i) the court simply did not cite the evidence on Perkin Elmer's knowledge/acquiescence; (ii) the court applied a rule found in comment g to § 202 of the Restatement to give interpretative effect to one party's unilateral conduct (*i.e.,* course of performance technically "does not apply to . . . to an action of one party only" but, nevertheless, "in such cases the conduct of a party may be evidence against him that he had knowledge or reason to know of the other party's meaning."); or (iii) the court applied the common law version of the course of performance rule (*i.e.,* "show me what the parties did under the contract and I will show you what the contract means"). I suspect that explanation (iii) is most likely because of the case quotation the court included in its analysis – "there is no surer way to find out the intent of the parties than to see what they have done," *New York Marine & Gen. Ins. Co. v. Lafarge North America, Inc.,* 599 F.3d 102, 119 (2d Cir. 2010).

[xv] "Where it is unreasonable to interpret the contract in accordance with the course of performance, the conduct of the parties may be evidence of an agreed modification or of a waiver by one party." Restatement, 2d, Contracts § 202, comment g.

[xvi] UCC § 1-303(f); *see also* UCC § 2-208(3) (Course of Performance or Practical Construction).

[xvii] *See, e.g., Daugherty Co. v. Kimberly-Clark Corp.*, 14 Cal.App.3d 151, 158 (1971)("An agreement to modify a written contract will be implied if the conduct of the parties is inconsistent with the written contract so as to warrant the conclusion that the parties intended to modify it," citing *Garrison v. Edward Brown & Sons* (1944) 25 Cal.2d 473, 479, 154 P.2d 377); *CT Chemicals, Inc. v. Vinmar, Inc.,* 81 N.Y.2d 174, 180-81 (NY 1993)("Once a contract is formed, the parties may of course change their agreement by another agreement, by course of performance, or by conduct amounting to a waiver or estoppel.")

[xviii] 211 F.Supp.2d 264 (D. Mass. 2002).

[xix] 211 F.Supp.2d at 282.

[xx] *Id.*