Dealing With a Contract's Invisible Terms:

Trade Usage, Course of Dealing, and Course of Performance

Prepared by:
Timothy Murray
Murray, Hogue & Lannis

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DEALING WITH A CONTRACT'S INVISIBLE TERMS

There are certain "invisible terms" that are part of every contract:

Trade Usage, Course of Dealing, and Course of Performance

Certain "invisible" terms that are easy to overlook in the drafting phase actually become part of the parties' contract: trade usage, course of dealing, and course of performance. The law reads these into contracts to cover areas not expressly addressed by the contract's express terms – they are actually part of the agreement: "'Agreement' . . . means the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . . ."[1]

These terms are frequently misused, even by courts. Here is how the UCC defines them:

> **§ 1-303. COURSE OF PERFORMANCE, COURSE OF DEALING, AND USAGE OF TRADE**
>
> (a) 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.
>
> (b) A "course of dealing" is a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.

[1] UCC § 1-201.

(c) A "usage of trade" is any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question. The existence and scope of such a usage must be proved as facts. If it is established that such a usage is embodied in a trade code or similar record, the interpretation of the record is a question of law.

(d) A course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware 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. A usage of trade applicable in the place in which part of the performance under the agreement is to occur may be so utilized as to that part of the performance.

(e) Except as otherwise provided in subsection (f), the express terms of an agreement and any applicable course of performance, course of dealing, or usage of trade must be construed whenever reasonable as consistent with each other. If such a construction is unreasonable:

(1) express terms prevail over course of performance, course of dealing, and usage of trade;

(2) course of performance prevails over course of dealing and usage of trade; and

(3) course of dealing prevails over usage of trade.

(f) Subject to Section 2-209, a course of performance is relevant to show a waiver or modification of any term inconsistent with the course of performance.

> (g) Evidence of a relevant usage of trade offered by one party is not admissible unless that party has given the other party notice that the court finds sufficient to prevent unfair surprise to the other party.

The *Restatement (Second) of Contracts* makes clear that these concepts are not limited to contracts for the sales of goods but are applicable to contracts in general.[2] For contracts for the sale of goods governed by the Uniform Commercial Code, and for common law contracts in some jurisdictions, evidence of trade usage and course of dealing may be admitted despite the parol evidence rule, even for completely integrated agreements.[3] Course of performance is not subject to the parol evidence rule since it involves post-formation conduct.

CASE STUDY—TRADE USAGE:

> ***"I'M JUST A HUMBLE COUNTRY LAWYER DOING THE BEST I CAN AGAINST THE BRILLIANT PROSECUTOR FROM THE BIG CITY OF LANSING."*** *(James Stewart, "Anatomy of a Murder")*

> ***Preminger et al., v. Columbia Pictures Corporation*, 49 Misc. 2d 363, 267 N.Y.S.2d 594 (1966)**

In one of the all-time great courtroom dramas -- Otto Preminger's *Anatomy of a Murder*–
Jimmy Stewart headed an all-star cast as a wily "country lawyer" who pretends to be out of his depth defending a murder trial.

Anatomy of a Murder trivia: the judge in the film was played by real-life attorney Joseph N. Welch, who had represented the U.S. Army in the televised Army-McCarthy hearings in 1954. Mr. Welch's rebuke of Senator Joseph McCarthy *("Have you no sense of decency, sir, at long last? Have you left no sense of decency?*) is widely credited as a factor in helping to bring an end to McCarthy's modern-day witch hunt.

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[2] See § 202(4) (course of performance); § 222 (usage of trade); and § 223 (course of dealing).
[3] U.C.C. §§ 1-201(b)(3), 1-303; Restatement (Second) of Contracts § 209, cmt (a) (Am. Law Inst. 1981); Restatement (Second) of Contracts §§ 221-224 (Am. Law Inst. 1981). C-Thru Container Corp. v. Midland Mfg. Co., 533 N.W.2d 542 (Iowa 1995) (U.C.C.); TDN Money Sys. v. Everi Payments, Inc., 2017 U.S. Dist. LEXIS 183223 (D. Nev. 2017) (non-U.C.C.); Diponio Contr. v. City of Howell, 2015 Mich. App. LEXIS 706 (2015) (non-U.C.C.). But see Hamilton Secs. Advisory Servs. v. United States, 2004 U.S. Claims LEXIS 147 (Fed. Cl. 2004) (merger clause bars evidence of such terms under common law).

After *Anatomy of a Murder's* theatrical run, the film's distributor, Columbia Pictures, licensed the film to over 100 television stations, and those license agreements purported to give the television stations the right to make minor cuts and to interrupt the film for commercials.

The film's director, Otto Preminger, and Preminger's production company that formally owned rights to the film, sued Columbia Pictures, seeking an injunction to prevent commercial interruptions and minor cuts in the film when it played on television. The case is reported at *Preminger et al., v. Columbia Pictures Corporation,* 49 Misc. 2d 363, 267 N.Y.S.2d 594 (1966).

In his suit, Preminger alleged that allowing television stations to interrupt for commercials and to make minor cuts detracted from the artistic merit of the film and falsely represented to the public that the film shown is Preminger's film when, he claimed, it wasn't. At the trial, Preminger made it clear he believed that what television did to his film was a "mutilation."

Preminger relied on a provision of the contract between his production company and Columbia providing that Preminger's production company "shall have the right to make the final cutting and editing of the Picture, but . . . shall in good faith consider recommendations and suggestions with respect thereto made by [Columbia]; nevertheless, [Preminger's production company] shall have final approval thereof . . .."

But the court rejected this argument, noting that this provision, which reserved to Preminger and his production company an express grant of "final" cutting and editing, was limited to *the original theatrical production* of the picture, not to airings on television.

The contract *did*, however, contain an express provision allowing Columbia to exhibit the film on television, but that provision made no reference to "cutting and editing." Given the contract's silence on this issue, exactly what rights did the television stations have?

The court held that *trade usage* supplied the answer. Specifically, "in the absence of specific contractual provision," Preminger and Columbia "will be deemed to have adopted the custom prevailing in the trade or industry." The court explained that "in the construction of a contract, weight will be given to the custom prevailing in the trade to which it refers." It proceeded to summarize the evidence admitted at trial:

> A review of the testimony demonstrates that, at least for the past 15 years, the right to interrupt the exhibition of a motion picture on television for

> commercial announcements and to make minor deletions to accommodate time segment requirements or to excise those portions which might be deemed, for various reasons, objectionable, has consistently been considered a normal and essential part of the exhibition of motion pictures on television.
>
> Implicit in the grant of television rights is the privilege to cut and edit.

The court concluded that "in the absence of any contractual provision to the contrary, [Preminger and his production company] must be deemed to have contemplated that what was permissible, under the existing practice, would continue in effect."

The court cited the licensing agreements between Columbia and the television stations to support the conclusion that the insertion of commercials would *not* interfere with the picture's story line: ". . . in no event may the insertion of any commercial material adversely affect the artistic or pictorial quality of the picture or materially interfere with its continuity." Moreover, evidence at trial was offered that "no station ever purchased a motion picture without reserving to itself the right to interrupt for commercials and to make minor cuts."

For his part, Preminger admitted that when he signed the agreement for *Anatomy of a Murder*, he was aware of the practice of the television industry to interrupt motion pictures for commercials and to make minor cuts, yet he did not expressly provide that such practices were prohibited. Indeed, in other film contracts, Preminger reserved for his production company the right to approve cuts made by television broadcasts.

CASE STUDY—COURSE OF PERFORMANCE:

Corbin on Contracts provides a cogent example—a discussion of *Bayer Chems. Corp. v. Albermarle Corp.*:[4]

> Albermarle agreed to supply 100 percent of Bayer's requirements of a C16-C18 compound, alkenyl succinic anhydride (ASA), used in the paper sizing

[4] Bayer Chems. Corp. v. Albermarle Corp., 171 Fed. App'x 392 (3d Cir. 2006) (the authors of these materials were among the attorneys for Bayer in this case).

industry. The parties' contract defined the ASA compound in this manner: "C16-C18 alkenyl succinic anhydride (hereinafter referred to as 'PRODUCT')." Importantly, the percentages of C16 and C18 were not mentioned in the express terms of the contract. Nevertheless, after contract formation, beginning in 1997, the formulation of the product that was actually supplied was this: 65 percent C16 and 35 percent C18.

Section 1.7 of the agreement stated that if Bayer decided to "reformulate or substitute another material or compound for Product," the parties would enter into negotiations to agree upon the supply of the new chemical. If an agreement was not reached following good-faith negotiations, then Bayer had the right to seek the supply of the chemical from a third party. Albermarle had the first right of refusal to match any third-party offer. Pursuant to this clause, in 2003, with two years remaining under the agreement, Bayer notified Albermarle that it wanted to reformulate the composition of the Product by changing the percentages of C16 and C18 from 65 percent C16 and 35 percent C18, to 75 percent C16 and 25 percent C18. Albermarle, however, claimed that under the express provisions of the parties' contract, the term "Product" did not establish any percentages of each component. It also pointed to the sales agreement's merger clause to argue that course of performance evidence was inadmissible to alter the agreement. It argued that it had the exclusive right to provide any formulation of C16/C18 that Bayer required—because of the broad definition given to Product in the contract. In essence, Albermarle argued that there was nothing to reformulate since the way the Product was originally defined in the contract encompassed Bayer's reformulation.

Bayer argued that the formula supplied since 1997—65 percent C16 and 35 percent C18—had become the contract formula via the parties' course of performance. Thus, Bayer argued it was

> permitted to invoke the reformulation clause when it sought to alter that formulation. The district court granted Bayer's motion for judgment on the pleadings. On appeal, the Third Circuit affirmed on the footing that the term "Product," as intended by the parties, was clearly defined not by the express words of the contract *but by the parties' course of performance* because the seller had manufactured and shipped the 65/35 product as 65 percent C16 and 35 percent C18, and the buyer had accepted that product on a continuous basis over several years. Course of performance was clearly demonstrated.[5]

DRAFTING TIPS:

The U.C.C. allows parties to "carefully negate" trade usage and course of dealing.[6] This requires words *in addition* to the usual merger clause.[7] If the parties want to negate trade usage and course of dealing, in the contract's merger clause, the caption of the merger clause should include a clear reference to the negation of trade usage and course of dealing, and something akin to the following sentence should be added to the merger clause: **"The parties also intend that this agreement may not be supplemented, explained, or interpreted by any evidence of trade usage or course of dealing."**

Course of performance technically cannot be negated since it involves conduct that occurs post-contract formation.[8] Merger clauses and the parol evidence rule only apply to things that happen *prior to or contemporaneous* with contract formation.[9] Even a well-drafted merger clause does not preclude a *post*-formation modification. Generally, "[p]arties to a contract cannot, even by an express provision in that contract, deprive themselves of the power to alter or vary or discharge it by subsequent agreement."[10] But some laws make no-oral modification clauses effective.[11]

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[5] Timothy Murray, Corbin on Contracts § 4.7 (Rev. ed. 2018).

[6] U.C.C. § 2-202, comment 2.

[7] Precision Fitness Equip., Inc. v. Nautilus, Inc., 2011 U.S. Dist. LEXIS 13576 (D. Colo. Feb. 2, 2011).

[8] U.C.C. § 2-202, official comment 2; K. Rowley, Contract Construction and Interpretation: From the "Four Corners" to Parol Evidence (and Everything in between), 69 Miss. L.J. 73, 331 (1999)(course of performance cannot be "carefully negated"); 1 William D. Hawkland, Uniform Commercial Code Series § 2-208:3, at 2-306 (1998)(no provision in U.C.C. to negate course of performance).

[9] E.g., Beal Bank S.S.B. v. Krock, 1998 U.S. App. LEXIS 22051 (1st Cir. 1998).

[10] Corbin on Contracts § 40.13. But "some courts and commentators believe that parties can opt out of the course of performance rule by explicitly stating so in the contract." Omri Ben-Shahar,

Good Faith and Fair Dealing

The best known of the "invisible terms" is the implied covenant of good faith and fair dealing. The good faith covenant is frequently invoked in litigation, rarely with success.

Per the words of § 205 of the Restatement (Second) of Contracts, "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[12] Contracts for the sale of goods under the U.C.C. "impose[ ] an obligation of good faith in its performance and enforcement."[13] The U.C.C. defines the duty of good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[14]

The duty of good faith applies where a term allows discretion in its performance. It cannot be applied to override an express provision. "Discretion" is the key word:

> Although courts recognize an implied duty of good faith and fair dealing, it "does not create an enforceable legal duty to be nice or to behave decently in a general way" and only "require[s] [a party] to exercise the discretion afforded to it by the. . . agreement in a manner consistent with the reasonable expectations of the parties." *Beraha v. Baxter Health Care Corp.*, 956 F.2d 1436, 1445 (7th Cir. 1992) (internal citation and quotation marks omitted)). Courts cannot simply "decide whether one party ought to have exercised privileges expressly reserved in the document. Rather 'good faith' is a compact reference to an

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Formalism in Commercial Law: The Tentative Case Against Flexibility in Commercial Law, 66 U. Chi. L. Rev. 781, 792 (1999). "One commentator has stated that sellers who are concerned that gratuitous services rendered may operate as a waiver of disclaimer clauses should include in the contract the following provision: 'If the seller, at its option, agrees to a waiver of any of the terms and conditions recited herein, such waiver shall not for any purpose be construed as a waiver of any succeeding breach of the same or any other terms or conditions of said contract; nor shall such a waiver be viewed as a course of performance.' Tracy, Disclaiming and Limiting Liability for Commercial Damages, 83 Com. L.J. 8, 20 (1978)." Or. Bank v. Nautilus Crane & Equip. Corp., 68 Ore. App. 131, 140, 683 P.2d 95, 101, n. 9 (1984). But this is a decidedly minority view.

[11] E.g., NY CLS Gen Oblig § 15-301 and U.C.C. § 2-209.

[12] E.g., Hanaway v. Parkesburg Grp., LP., 168 A.3d 146 (Pa. 2017).

[13] UCC § 1-304.

[14] UCC § 1-201 (b)(20).

> implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting." *Paramont Properties*, 588 F. Supp. 2d at 857 (citing Lapides, 2003 U.S. Dist. LEXIS 2901, 2003 WL 722237, at *15 (quoting *Kham & Nate's Shoes No. 2. Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990)). Moreover, where a defendant is not alleged to violate a specific obligation, the implied duty as a tool of construction is not relevant because it does not permit enforcement of an obligation not present in the contract.[15]

The Pennsylvania Suggested Standard Civil Jury Instructions[16] describes the duty:

> This implied duty of good faith and fair dealing applies only to discretionary [duties] [obligations] under the contract. It does not create new obligations or obligations inconsistent with specific terms in the contract.
>
> Duties or obligations are discretionary when a party has some degree of choice in how to perform [his] [her] [its] obligation[s] under the contract.
>
> A party should not do anything to destroy or injure the other party's right to receive the benefits of the contract. Therefore, even discretionary duties and obligations must be performed in a reasonable manner consistent with the contract's purposes.

The duty is often described by courts in rather amorphous terms, replete with legal platitudes about fairness and "evasion of the spirit of the bargain"—which are not especially helpful. In *Corbin on Pennsylvania Contracts*, the author of these materials wrote:

> As a practical matter, the covenant generally is applied where a contractual provision allows a party discretion in the manner of its performance and that

[15] RLI Ins. Co. v. Nexus Servs., 2018 U.S. Dist. LEXIS 145789, *8-9 (W.D. Va. 2018).

[16] Timothy Murray, co-author of these materials, helped to write the suggested Pennsylvania jury instructions for contract law in 2017.

> discretion is exercised in bad faith to deprive another party to the transaction the fruits of its reasonable expectations under the contract.
>
> In contrast, where a party does what the contract expressly allows it to do, there can be no breach of the implied covenant of good faith because the covenant cannot override express contract terms.
>
> The covenant is not a free-floating obligation and it does not exist in the air. It only exists when a specific contractual provision creates it—it springs from and is grounded in express contractual provisions that allow discretion in their performance. Thus, a claim for breach of the implied covenant does not exist independent from the contract itself.
>
> The covenant is very often misused to argue that duties are owed under the contract even though no specific contractual provision is invoked. This is nothing more than asking the court to rewrite the contract to create rights and obligations that the parties themselves did not bother to include in their memorial of the deal. In sum, the covenant is only properly invoked where a specific provision under the contract allows a party discretion in its performance and that discretion is exercised in bad faith.[17]

DRAFTING TIP: To guard against good faith claims, drafters need to focus on provisions that allow discretion in the manner of performance. It is often impossible to eliminate discretion or to spell out every facet of performance, but not always.

The UCC provides: "The obligations of good faith, diligence, reasonableness, and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable."[18]

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[17] Timothy Murray & Jon Hogue, Corbin on Pennsylvania Contracts § 26.01[4] (2019).
[18] U.C.C. § 1-302(b).