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COURSE OF PERFORMANCE AS EVIDENCE OF INTENT OR WAIVER: A MEANINGFUL PREFERENCE FOR THE LATTER AND IMPLICATIONS FOR NEWLY BROADENED USE UNDER REVISED U.C.C. SECTION 1-303

*Jack M. Graves**

TABLE OF CONTENTS

I.	Introduction.....	236
II.	The Historical and Analytical Underpinnings of Section 2-208..	239
	A. Historical Development	239
	B. Comparison with International Sale of Goods Law	243
	C. Leaving Course of Performance in Article 2	245
III.	Analytical Challenges in the Use of Course of Performance	
	Evidence As an Aid in Interpretation Under Section 2-208	248
	A. The Interpretation of Agreements.....	248
	B. Revisiting <i>Nanakuli</i>	252
	C. The Inherent Ambiguity of a Course of Performance.....	258
	D. A Problem of Circularity.....	264
	E. A Question for the Court.....	265
	F. Mixing Inferences of Intent in <i>Nanakuli</i>	267
IV.	The Use of Course of Performance Evidence to Interpret the	
	Parties' Prior Agreement Discourages Cooperative	
	Commercial Behavior.....	269
	A. Cooperation, Dispute Resolution, and Course of	
	Performance Evidence	269
	B. Preserving One's Rights	272
	C. Following by Analogy the Wisdom of Federal Rule of	

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Evidence 408.....	274
D. The Problem of Reliance	275
E. Contracting Around Course of Performance Evidence	276
V. Waiver Represents a Better Application of Course of Performance Evidence in Protecting the Reasonable Expectations of All Parties	277
A. Waiver as a Balanced Approach	277
B. Further Benefits of the Doctrine of Waiver	280
VI. A Meaningful Preference for Waiver Takes on Increasing Importance When Course of Performance Is Applied Broadly Throughout the Code Under Section 1-303.....	282
A. The Use of Course of Performance Evidence Outside of Article 2.....	282
B. Potential New Uses of Course of Performance Evidence.....	286
VII. Conclusion	293

I. INTRODUCTION

Karl Llewellyn's broad vision for the Uniform Commercial Code was to incorporate normative commercial practices into the commercial body of law—or turn immanent commercial norms into immanent law.¹ The overall effectiveness of the Code's broad incorporation strategy in promoting and preserving commercial norms is subject to substantial scholarly critique.² However, this Article focuses specifically on a single

1. See Richard Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 624 (1975) (“To [Llewellyn] an ‘immanent law’ lay embedded in any situation and the task of the law authority was to discover it.”); Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. CHI. L. REV. 781, 782 (1999) (referring to “[t]he Code’s underlying jurisprudential theory of immanent law”).

2. For example, Lisa Bernstein has produced significant work in comparing various industry-specific private legal systems with the incorporation approach of the Code and arguing broadly that the Code's incorporation approach has in fact done more harm than benefit to the very commercial norms it seeks to protect. See, e.g., Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) [hereinafter Bernstein, *Merchant Law*]; Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999) [hereinafter Bernstein, *Questionable Empirical Basis*]. In this Article, I rely on some of Professor Bernstein's empirical work and agree with much of her analysis. However, I draw distinctions between course of performance evidence and other contextual evidence, such as course of dealing and usage of trade, which I believe mandate

element of Llewellyn's incorporation strategy: the use of "course of performance"³ evidence to interpret agreements under the Uniform Commercial Code.⁴

Course of performance evidence is the only evidence used to interpret an agreement's original terms that does not come into existence until *after* formation of the agreement in question.⁵ As such, it is unquestionably unique. In this Article, I suggest that the use of course of performance evidence to interpret prior agreements is also of questionable wisdom because: (1) it is analytically flawed in light of basic contract theory; and (2) it is poor policy in light of the commercial norms the Code seeks to promote. I further suggest that the doctrine of waiver presents a superior alternative for giving effect to parties' postformation conduct, inasmuch as it avoids the analytical flaws and provides for a more balanced set of commercial effects than those likely to arise from the use of course of performance to interpret the parties' prior agreement. I then move on to discuss new challenges in the application of course of performance evidence under revised Article 1 of the Code.

Until quite recently, the statutory use of course of performance

differing treatment.

3. U.C.C. § 1-303(a) (2001). "A course of performance is a sequence of conduct between the parties to a particular transaction" wherein: (1) the parties' agreement involves "repeated occasions for performance" by party A; and (2) party B, "with knowledge of the nature" of A's performance and opportunity to reject it, accepts or acquiesces in A's performance without objection. U.C.C. § 1-303(a) (2001) (formerly U.C.C. § 2-208(1)).

4. In the current version of the Uniform Commercial Code, course of performance evidence is addressed in Article 1, in U.C.C. section 1-303, and is therefore applicable to the entire Code. See U.C.C. § 1-102 (2001) ("This article applies to a transaction to the extent it is governed by another article of [the Uniform Commercial Code]."). In contrast, from the inception of the Code until 2001, course of performance evidence was addressed in Article 2, in U.C.C. section 2-208, and was applicable only to transactions in goods within the scope of Article 2. See U.C.C. § 2-102 (2003) ("[T]his Article applies to transactions in goods . . .").

5. See Douglas K. Moll, *Reasonable Expectations v. Implied-In-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1035 n.179 (2001) (noting that course of performance evidence often relates to conduct that occurred after the agreement). Some courts would look to postformation events for commercial standards defining good faith. See, e.g., *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 805-06 (9th Cir. 1981) (defining good faith based on postformation conduct). But see *id.* at 806 (Kennedy, J., concurring) (limiting the definition of good faith to commercial standards effective at the time of contracting). Whether or not one looks to postformation conduct in defining good faith, this is arguably different than looking to postformation conduct to interpret the terms of the parties' agreement itself.

evidence to interpret agreements was, at least arguably, limited to Article 2 of the Uniform Commercial Code.⁶ However, with the 2001 revisions, course of performance evidence is now addressed in Article 1,⁷ and is, therefore, applicable throughout the Code.⁸ Thus, any challenges presented by the use and application of course of performance evidence now implicate other portions of the Code, such as negotiable instruments under Article 3, banking law under Article 4, letters of credit under Article 5, and security interests under Article 9.⁹ While the drafters of revised Article 1 appear to have recognized at least one potential problem with the application of course of performance evidence to negotiable instruments under Article 3,¹⁰ this Article discusses the potential for additional challenges under Article 3 and throughout the Code. With its broadened applicability under revised section 1-303, the use and application of course of performance evidence takes on additional importance under the uniform version of the Code, and the issue is particularly pertinent today, as state legislatures consider whether to adopt the various new revisions to Article 1.¹¹

6. See *supra* note 4.

7. U.C.C. § 1-303 (2001).

8. See *supra* note 4. The revisions, of course, affect only the uniform law, and will not take legal effect in any jurisdiction until adopted by the legislature. See Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 137 (1996) (noting that proposals by the National Conference of Commissioners on Uniform State Laws (NCCUSL) are ineffective unless and until they are adopted by state legislatures).

9. See *supra* note 4.

10. See U.C.C. § 1-303 cmt. (2001) (noting that course of performance evidence may not be used to establish a defense against a holder in due course of a negotiable instrument). While noting at least one potential issue, this comment falls far short of providing guidance for the full panoply of issues likely to arise in attempting to apply course of performance evidence under Article 3. See discussion *infra* Part VI.B.

11. To date, the revisions to Article 1 have been introduced in only a few state legislatures, and only Virginia, Texas, and the Virgin Islands have enacted these revisions. TEX. BUS. & COM. CODE ANN. §§ 1.101-.310 (Vernon 1994 & Supp. 2004); VA. CODE ANN. §§ 8.1A-101 to -310 (Michie Supp. 2003); 11A V.I. CODE ANN. §§ 1-101 to -310 (Supp. 2003). Both Texas and Virginia enacted nonuniform versions of U.C.C. section 1-301, which has proven quite controversial with its revised choice of law provisions. TEX. BUS. & COM. CODE ANN. § 1.301; VA. CODE ANN. § 8.1A-301. Compare Richard K. Greenstein, *Is the Proposed U.C.C. Choice of Law Provision Unconstitutional?*, 73 TEMP. L. REV. 1159 (2000) (discussing implications of U.C.C. § 1-301), and William J. Woodward, Jr., *Contractual Choice of Law: Legislative Choice in an Era of Party Autonomy*, 54 SMU L. REV. 697 (2001) (addressing U.C.C. Article 1), with Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151 (2000) (proposing a new comprehensive system for choice of law).

Part II of this Article explores the historical development and analytical underpinnings of the use of postcontractual conduct, as ultimately addressed as course of performance evidence under section 2-208. I discuss the new analytical construct introduced by the Code, and compare this construct with the treatment of subsequent conduct under earlier domestic law and under current international law, as codified in the United Nations Convention on Contracts for the International Sale of Goods. Part III explains why the use of course of performance evidence, as provided for in the Code, is analytically inconsistent with both basic contract theory and other Code provisions. These analytical inconsistencies are further developed in the context of a classic contracts interpretation case decided under the Code. Part IV discusses the policy issues that cut against using course of performance evidence to interpret parties' prior agreements. I explain why these policy issues call into question using course of performance evidence for interpretation, even if such evidence may have some limited logical relevance with respect to interpretation of the parties' agreement. Part V explains why the application of the doctrine of waiver to postformation conduct represents a preferable alternative to the use of a course of performance as an aid in interpretation of the parties' prior agreement. Finally, Part VI looks at previous Code decisions discussing the potential use of course of performance evidence outside the scope of Article 2 and the potential implications of these decisions on the newly broadened use of course of performance evidence under section 1-303. I then discuss a few of the specific new problems likely to arise from using course of performance evidence in combination with other Code Articles.

II. THE HISTORICAL AND ANALYTICAL UNDERPINNINGS OF SECTION 2-208

A. Historical Development

The treatment of course of performance evidence under section 2-208¹² was one of a number of novel principles originally introduced by the

12. Section 2-208 has been withdrawn and removed from the current uniform version of Article 2, and the treatment of course of performance evidence is now addressed in section 1-303 of revised uniform Article 1. *See* U.C.C. § 2-208 (withdrawn 2001); *id.* § 1-303 (2001). Some of the potential implications of that change are discussed in Part VI; however, I will continue to refer to former section 2-208 (as well as former section 1-205, which addressed course of dealing and trade usage evidence before their move to section 1-303) in Parts III, IV, and V. Article 2 was also amended in 2003. *See* U.C.C. art. 2 (2003). These amendments

Code.¹³ Under section 2-208, certain conduct by the parties to an agreement, occurring after the execution of the agreement itself, was deemed relevant to the original meaning of the previously formed agreement.¹⁴ Course of performance evidence is, at least in theory, easily distinguishable from evidence of a course of dealing—which involves preformation conduct between the parties under a prior agreement—or a usage of trade—which involves preformation conduct within a commercial trade or trades relevant to the parties' own transaction.¹⁵ All three of these forms of evidence of contractual intent were afforded special significance when interpreting agreements within the scope of Article 2.¹⁶ Course of performance evidence, however, was given the greatest weight of all, always trumping a course of dealing or trade usage,¹⁷ and frequently even trumping the parties' express contractual terms.¹⁸ This extraordinary elevated status of the parties' postformation conduct was not necessarily a foregone conclusion in the development of commercial law, prior to its inclusion in the original Code.

The predecessor of Article 2, the Uniform Sales Act, did not define or employ the term "course of performance" at all.¹⁹ In fact, the clearest articulation of the concept is found in section 235(e) of the *Restatement (First) of Contracts*, which provides that "the conduct of the parties subsequent to a manifestation of intention" may be used as an aid in

should have no effect on the foregoing analysis. In any section in which the 2003 amendment to Article 2 has any relevance to the analysis, such relevance is explained in the note or accompanying text.

13. See UNIFORM REVISED SALES ACT § 22 (Proposed Final Draft No. 1, Apr. 27, 1944), reprinted in 2 ELIZABETH SLUSSER KELLY, UNIFORM COMMERCIAL CODE DRAFTS 1, 24 (1984) [hereinafter 1944 Draft] (providing the initial articulation of a "course of performance"); UNIFORM COMMERCIAL CODE § 2-208 (1949), reprinted in UNIFORM COMMERCIAL CODE DRAFTS 1, 75-77 (1984) [hereinafter 1949 Draft] (showing the renumbering of earlier section 22, now as section 2-208); see also Danzig, *supra* note 1, at 631-34 (describing Llewellyn's "radical innovations" in both the form and substance of Article 2, including sections 2-201 and 2-206); U.C.C. § 2-101 cmt. (2003) (explaining that Article 2 is more extensive than the former Sales Act and includes bodies of law developed outside of that Act).

14. U.C.C. § 2-208(1) (withdrawn 2001).

15. U.C.C. § 1-205(1)-(3) (2001).

16. See U.C.C. § 2-202(a) (2003) (affording special significance to evidence of a course of performance, a course of dealing, and a trade usage).

17. U.C.C. § 2-208(2) (withdrawn 2001).

18. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3-3 (5th ed. 2000).

19. See generally UNIF. SALES ACT § 1 (superseded 1952), 1 U.L.A. 2 (1950).

contract interpretation.²⁰ In the Act, the only use of the term “conduct of the parties” (before or after contract formation) is found in section 18, dealing with passing of property rights in goods.²¹ Sections 9 and 71 of the Act discuss a course of dealing or custom as perhaps relevant in determining the parties’ contractual rights and duties, but do not specifically mention postformation conduct.²²

In short, the Act simply did not provide for the use of postformation conduct as a general source of contract interpretation. Thus, it is unsurprising to discover that, while section 1-205 of the Code provided ample prior statutory support for its treatment of course of dealing and trade usage,²³ section 2-208 provided no such specific references.²⁴ A course of performance, as described in section 2-208, had no distinctly identified significance under the Act.²⁵

The treatment of postformation conduct in the *Restatement (First) of Contracts* is also far more limited than that of course of performance under section 2-208. Section 235(e) of the *Restatement (First) of Contracts* provides that subsequent conduct may be relevant in determining the parties’ intent where “all parties placed a particular interpretation upon

20. RESTATEMENT (FIRST) OF CONTRACTS § 235(e) (1932).

21. UNIF. SALES ACT § 18 (superseded 1952), 1 U.L.A. 311 (1950).

22. UNIF. SALES ACT § 9 (superseded 1952), 1 U.L.A. 158 (1950); UNIF. SALES ACT § 71 (superseded 1952), 1A U.L.A. 410 (1950). The treatment of course of dealing evidence in these two sections came directly from the English Sale of Goods Act. See 1 SAMUEL WILLISTON, THE LAW GOVERNING SALES OF GOODS AT COMMON LAW AND UNDER THE UNIFORM SALES ACT § 166 n.1 (3d ed. 1948) (stating that section 9 of the act was based on section 8 of the English Sale of Goods Act); 3 WILLISTON, *supra*, § 617 (stating that section 71 was “copied from section 55 of the English Sale of Goods Act”). Under the Uniform Sales Act, a course of dealing was limited to preformation conduct in essentially the same manner as it was under U.C.C. section 1-205. See 1 WILLISTON, *supra*, § 167 (explaining the application of course of dealing evidence as informing the understanding of a reasonable objective person at the time of contracting); see also *Moore v. Am. Molasses Co.*, 174 N.Y.S. 440, 442 (Sup. Ct. 1919) (explaining that the parties’ course of dealing under previous contracts is the best evidence of intent under a current contract calling for the same performance). But see *Matthes v. Benn*, 176 N.Y.S. 770, 770-71 (App. Div. 1919) (applying implicitly the theories of waiver or estoppel to vary the parties’ contractual rights based on postformation conduct, which here is called a “course of dealing,” but not providing any support for the idea of using postformation conduct to interpret the prior agreement).

23. U.C.C. § 1-205 cmt. (2001).

24. U.C.C. § 2-208 cmt. (withdrawn 2001).

25. See generally UNIF. SALES ACT (superseded 1952), 1 U.L.A. 2 (1950).

it.”²⁶ The single illustration in support of clause (e) of section 235 describes circumstances in which the party against whom the postformation conduct is being used: (1) takes affirmative steps in order to effectuate the asserted meaning; (2) expressly states their understanding of the prior agreement based on the asserted meaning; and (3) acquiesces in the other party’s express statements regarding the prior agreement, basing such acquiescence on the same asserted meaning.²⁷ That such pervasive and repeated conduct might be used to prove the prior intent of the parties is hardly surprising. In fact, the express statements of the parties are in the nature of admissions with respect to subjective intent.²⁸ However, in drafting what would become section 2-208 of the Code, Llewellyn took a significant step beyond the *Restatement (First) of Contracts* approach.

Section 2-208 allowed silence alone to be used to interpret a prior agreement against the silent party.²⁹ This was an unprecedented use of postformation conduct to interpret the parties’ agreement and one that, until recently, remained largely unique to Article 2 of the Code. The current treatment of postformation conduct under the United Nations Convention on Contracts for the International Sale of Goods (CISG)³⁰ provides a useful comparison³¹ with the treatment of course of performance evidence under section 2-208.

26. RESTATEMENT (FIRST) OF CONTRACTS § 235(e) (1932).

27. *Id.* § 235(e) cmt. h, illus. 11.

28. See discussion *infra* Part III.A.

29. See U.C.C. § 2-208(1) (withdrawn 2001) (“Where the contract for sale 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 shall be relevant to determine the meaning of the agreement.”).

30. Final Act of the United Nations Conference on Contracts for the International Sale of Goods, Apr. 10, 1980, U.N. Doc. A/Conf. 97/18, with Annex, United Nations Convention on Contracts for the International Sale of Goods, *reprinted in* 19 I.L.M. 668 (1980) [hereinafter CISG].

31. Today, we see courts in this country looking more often to international law in addressing difficult issues arising under our own laws and Constitution. See, e.g., *Lawrence v. Texas*, 123 S. Ct. 2472, 2481 (2003) (discussing international treatment of homosexual conduct between consenting adults in addressing the constitutionality of the Texas statute barring such conduct); *Grutter v. Bollinger*, 123 S. Ct. 2325, 2347 (2003) (Ginsburg, J., concurring) (citing an international treaty, to which the United States is a party, in support of the continuing validity of affirmative action under appropriate circumstances).

B. Comparison with International Sale of Goods Law

Article 8(3) of the CISG provides that a tribunal engaged in determining the intent of contracting parties may consider all relevant circumstances, including, *inter alia*,³² “any subsequent conduct of the parties.”³³ The primary import of Article 8(3) is to expressly establish the inapplicability of any domestic rule barring any parol evidence.³⁴ Unlike Code sections 1-205 and 2-208, CISG Article 8 does not establish any formal hierarchy for such extrinsic evidence.³⁵ However, the parties’ precontractual negotiations likely will be most relevant, closely followed in importance by the parties’ prior practices³⁶ and trade usage, as evidence of objective intent.³⁷ At the bottom of the list is subsequent conduct, as a possible indication of the parties’ prior common intent.³⁸

CISG Article 9 more fully develops the use of practices that the parties have established between themselves and usages as aids in interpretation (equivalent to course of performance and usage of trade under the Code) impliedly establishing a hierarchy between them.³⁹ However, nowhere does Article 9 or any other Article of the CISG make any further reference to subsequent conduct as a specific aid to interpretation of a prior agreement. A fortiori, the CISG does not establish that silent acquiescence, by itself, may be used to interpret the

32. Negotiations, prior practices between the parties, and usages are also included. CISG, *supra* note 30, at art. 8(3).

33. *Id.*

34. JOHN O. HONNOLD, UNIFORM LAW FOR INTERNATIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION 121-123 (3d ed. 1999); *see also* MCC-Marble Ceramic Ctr., Inc. v. Ceramica Nuova D’Agostino, 144 F.3d 1384, 1388-89 (11th Cir. 1998) (stating that although the CISG “contains no express statement on the role of parol evidence,” article 8(3) instructs that parol evidence should be admitted and considered “to the extent [it] reveal[s] the parties’ subjective intent”).

35. *See* COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 69, 70 (Peter Schlechtriem ed., Geoffrey Thomas trans., 2d ed. 1998) [hereinafter COMMENTARY ON CISG].

36. “[P]ractices which have developed between the parties” under the CISG are equivalent to a “course of dealing” under U.C.C. § 1-205. COMMENTARY ON CISG, *supra* note 35, at 70 n.2b.

37. *Id.* at 70.

38. *Id.* The use of postformation conduct to attempt to determine common subjective intent is more fully developed in Part III.A.

39. *Id.* at 78. *Compare id.* at art. 9(2) (impliedly making other usages part of the parties’ agreement, provided the parties knew or should have known, and provided the parties have not otherwise agreed), *with* CISG, *supra* note 30, at art. 9(1) (binding parties to agreed upon usages or practices they have established between themselves).

parties' prior agreement. While subsequent conduct undoubtedly has some relevance under Article 8(3),⁴⁰ there is no indication that it should be considered the "best indication" of the parties' intent, as mandated under section 2-208.

We thus find, in both pre-Code domestic law and current international statutory law governing the sale of goods, a more limited use of postformation conduct as relevant to interpreting the terms of the parties' prior agreement. However, from its earliest articulation in the revision process of the Uniform Sales Act—which ultimately became Article 2 of the Code—any course of postformation performance "accepted without objection" was deemed to be relevant to the meaning of the parties' prior agreement.⁴¹ Such evidence was not only relevant to a determination of intent, but also was "the best indication of" the meaning of the parties' agreement.⁴² This treatment of course of performance was absolutely unique at the time.⁴³

40. See HONNOLD, *supra* note 34, at 123 (explaining that Article 8(3) of the CISG provides for "due consideration" of subsequent conduct and contrasting the treatment of course of performance evidence under former U.C.C. § 2-208 with English case law rejecting the use of postformation evidence as an aid in the interpretation of a contract) (quoting CISG, *supra* note 30, at art. 8(3)); see also COMMENTARY ON CISG, *supra* note 35, at 71 (explaining that conduct may serve to trump a party's stated declaration, but supporting the explanation based on the recipient's view of the other party's outward manifestations under objective contract theory—an analysis that is arguably limited to preformation conduct, as explained in Part III.A.).

Australian contract law also finds some support for the English rule rejecting any use of subsequent conduct in contract interpretation. Stephen Charles, *Interpretation of Ambiguous Contracts by Reference to Subsequent Conduct*, 4 J. CONT. L. 16, 22 (1991) (citations omitted). While the English rule has received significant criticism by Australian scholars, even its critics argue only for its application to otherwise ambiguous contracts. *Id.* at 35. Such ambiguity is not required under Article 2. U.C.C. § 2-202 (2003).

41. 1944 Draft, *supra* note 13, § 22.

42. U.C.C. § 2-208 cmt. 1 (withdrawn 2001).

43. The similar treatment of course of performance evidence in *Restatement (Second) of Contracts* section 202(4) (1981) simply followed the prior introduction of the concept in the Code. See RESTATEMENT (SECOND) OF CONTRACTS § 202 Reporter's Note (1981) (explaining that the former terminology from section 235(e) of the *Restatement (First) of Contracts* had been replaced using the terminology of section 2-208); see also Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 COLUM. L. REV. 833, 845 (1964) (explaining that the language of section 2-208 was "clear and more restrictive" than that found in prior judicial opinions).

C. Leaving Course of Performance in Article 2

There was also one other interesting development in the incorporation of course of performance evidence into the eventual official Code text. From the beginning, the combined treatment of course of dealing and usage of trade evidence was addressed separately from that of course of performance; the former two were both included in section 21 of the Uniform Revised Sales Act, while the latter was included in section 22.⁴⁴ Presumably, they were treated separately because they were analytically distinct—with course of dealing and trade usage both predating formation and course of performance following it.⁴⁵ This apparent dichotomy, as well as the individual section numbers, was maintained when both sections were initially carried over into the draft Code in 1948.⁴⁶ However, in 1949, when the Code drafters were deciding which provisions of the individual articles should be given broad applicability by their inclusion in Article 1, the split became significantly more pronounced. Section 22 became U.C.C. § 2-208, remaining narrowly cabined within the scope of Article 2.⁴⁷ However, section 21 was moved to Article 1, where it became U.C.C. § 1-205 and was thus made broadly applicable throughout the Code.⁴⁸ These changes are handwritten over the printed 1948 draft without any explanation for the differing treatment.⁴⁹

I have been unable to find any definitive explanation as to why course of performance was left in Article 2 when course of dealing and trade usage were moved to Article 1. Nothing in the history of the drafting process or Llewellyn's papers relating to the drafting of the Code explains this decision.⁵⁰ Hawkland and Miller note this distinction and suggest that

44. 1944 Draft, *supra* note 13, §§ 21-22. Karl Llewellyn is recognized as the single most influential force behind the drafting efforts of both the revision of the Uniform Sales Act and the new Uniform Commercial Code. See WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT 270-85 (1985) (discussing Llewellyn's extensive involvement and contribution to the drafting of both the Uniform Sales Act and Uniform Commercial Code). Nevertheless, both are also recognized as collaborative efforts. *Id.*

45. This analytical distinction is more fully developed in Part III.A.

46. THE CODE OF COMMERCIAL LAW (1948), reprinted in 5 KELLY, *supra* note 13, §§ 21-22 [hereinafter 1948 Draft].

47. The Karl Llewellyn Papers, J, XI, 1d (on file with the University of Chicago Law Library). Compare 1948 Draft, *supra* note 46, §§ 21-22, with 1949 Draft, *supra* note 13, §§ 1-205, 2-208.

48. 1949 Draft, *supra* note 13, §§ 1-205, 2-208.

49. *Id.*

50. See generally The Karl Llewellyn Papers, *supra* note 47; TWINING, *supra* note 44; Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the*

course of performance had originally been relegated to Article 2 “apparently on the assumption that course of performance is closely connected to sale[s] . . . transactions, while [course of dealing and trade usage] have more general application.”⁵¹ However, it is hard to understand why one would be any more or less likely to encounter contracts involving “repeated occasions for performance”⁵² in sales of goods contracts, as opposed to other contracts addressed by the Code. Many commentators simply state that course of performance obviously belongs with course of dealing and trade usage in Article 1, without discussing any possible explanation for its initial separation.⁵³

For example, one could easily imagine “repeated occasions for performance” in a negotiable note governed by Article 3, a banking relationship governed by Article 4, a letter of credit governed by Article 5, or a security agreement governed by Article 9.⁵⁴ In fact, contemplations such as these may have led the drafters to consciously leave course of performance in Article 2.⁵⁵

Merchant Rules, 100 HARV. L. REV. 465 (1987).

51. WILLIAM D. HAWKLAND & FREDERICK H. MILLER, UNIFORM COMMERCIAL CODE SERIES § 1-303:1 n.2 (1982 & Supp. 2002).

52. U.C.C. § 2-208(1) (withdrawn 2001).

53. See, e.g., PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB COMMENTARY ON THE UNIFORM COMMERCIAL CODE: COMMENTARY NO. 10 (SECTION 1-203), 7 n.8 (Final Draft Feb. 10, 1994) [hereinafter PEB COMMENTARY]. The PEB Commentary recognizes the original separation, but nonetheless opines that “there exists no plausible justification for excluding” section 2-208’s treatment of course of performance from Article 1. *Id.* As explained by the commentary, and as developed further in Part VI.A, some courts have relied on the inclusion of course of performance in the definition of “agreement” under U.C.C. § 1-201. *Id.*; see also discussion *infra* Part VI.A. However, this definition was part of the same original 1949 draft that moved course of dealing and trade usage to Article 1 (the apparent contrary assertion in the PEB Commentary is not correct), while leaving course of performance in Article 2. Thus, the more reasonable interpretation of the definition of “agreement” under section 1-201 is that an agreement might include a course of performance, provided the agreement was within the scope of Article 2. See PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ARTICLE 2: PRELIMINARY REPORT 32 (1990) (emphasizing the importance of U.C.C. section 1-205 within the broad definition of agreement, applicable throughout the Code, and suggesting that course of performance should also be made broadly applicable rather than narrowly limited to sales). However, the three have always been grouped together in section 2-202 of Article 2. See U.C.C. § 2-202(a) (2003).

54. See discussion *infra* Part VI.B.

55. This idea should be credited to John A. Spanogle, Jr., William Wallace Kirkpatrick Professor of Law, George Washington University, who observed when I

In a 1954 report, a special committee of the American Bankers Association expressed serious reservations about the flexible and uncertain nature of the Code in general and, in particular, proposed section 1-205, which addresses course of performance and trade usage.⁵⁶ The report also discussed concerns about significant changes in the law of sales under Article 2, focusing primarily on changes in passage of title, but ultimately minimizing any Article 2 concerns because banking transactions seldom involve sales of goods questions governed by Article 2.⁵⁷ If bankers were concerned about the negative effects caused by the treatment of preformation course of dealing and trade usage under section 1-205, it certainly stands to reason that these same bankers would have been even more concerned if the treatment of course of performance under U.C.C. § 2-208 had also been imported into Article 1. Perhaps the most obvious concern would arise with using course of performance to interpret the terms of a negotiable note.⁵⁸

Thus, it seems a reasonable assumption that the drafters of the Code consciously left behind their novel treatment of course of performance in Article 2 out of concern that the concept was either inappropriate for broader application or would simply encounter too much resistance in that context.⁵⁹ Whether accurate or not, the theory does invite some interesting questions now that course of performance has been united with course of dealing and trade usage in revised section 1-303. However, before addressing these questions in Part VI, I will explore, in Parts III and IV, a number of significant problems with the use of course of performance evidence for interpretation under Article 2 and discuss a preferable alternative in Part V. The foregoing analysis of course of performance evidence in its Article 2 context also lays the groundwork for new

raised the question with him in conversation. Although I have failed in my search to either prove or disprove his hypothesis, I believe it is the most reasonable explanation offered.

56. See AM. BANKERS ASS'N, REPORT OF COMMITTEE ON UNIFORM COMMERCIAL CODE 15-16 (1954) (stating the Code's "greatest weakness" is its "limited precision and certainty").

57. *Id.* at 19-20.

58. This issue, as it now arises under section 1-303, is explored more fully in Part VI.B.

59. One other possible reason for limiting section 2-208 to Article 2 is that the conduct of the parties is given increased significance, generally, in Article 2. See, e.g., U.C.C. § 2-204(1) (2003) (providing for formation based on conduct). Perhaps Llewellyn believed that conduct under the actual agreement in question, as opposed to an earlier course of dealing or established trade usage, was somehow uniquely relevant to mercantile law and, therefore, uniquely applicable under Article 2.

implications of the use of such evidence under revised Article 1 in Part VI.

III. ANALYTICAL CHALLENGES IN THE USE OF COURSE OF PERFORMANCE EVIDENCE AS AN AID IN INTERPRETATION UNDER SECTION 2-208

A. *The Interpretation of Agreements*

Whenever interpreting the parties' contractual intent, our starting point is a search for shared subjective intent.⁶⁰ If the parties attach the same meaning to their agreement, our inquiry ends—right then and there.⁶¹ In effect, we recognize the parties' right to use words between themselves in whatever manner they may choose—as long as they agree on exactly what they meant.⁶² If the parties do not share a common subjective intent,⁶³ we next ask whether one party knew, at the time of formation, of an unshared subjective meaning attached by the second party.⁶⁴ If so, then the contract is enforced according to the subjective meaning attached by the innocent second party.⁶⁵ In effect, a party that knew of the other party's subjective disagreement at the time of formation, but failed to raise the issue at that time, will be estopped from raising the subjective disagreement later. Predictably, most disputes are not resolved by either of these approaches involving searches for subjective intent. This brings us to the process of objective contract interpretation.

60. See RESTATEMENT (SECOND) OF CONTRACTS § 201(1) (1981) ("Where the parties have attached the same meaning to a promise or agreement or a term thereof, it is interpreted in accordance with that meaning."); see also CISG, *supra* note 30, at art. 8(1) ("For the purposes of this Convention statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what that intent was.").

61. The pure objectivist approach, as expressed by Judge Learned Hand in *Eustis Mining Co. v. Beer*, Sondheim & Co., 239 F. 976, 984 (S.D.N.Y. 1917) (explaining the notion that "[i]t makes not the least difference whether a promisor actually intends that meaning which the law will impose upon his words") has little, if any, currency today.

62. See RESTATEMENT (SECOND) OF CONTRACTS § 201(1) ("Where the parties have attached the same meaning to a promise or agreement or a term thereof, it is interpreted in accordance with that meaning.").

63. The lack of a shared subjective intent is obviously quite likely in the context of a dispute over the interpretation of a contract.

64. RESTATEMENT (SECOND) OF CONTRACTS § 201(2)(a).

65. *Id.*; see also CISG, *supra* note 30, at art. 8(1) ("[S]tatements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what the intent was.").

Where the parties do not share a common subjective interpretation, and neither knew of the other's differing interpretation at the time of formation, we adopt whichever subjective interpretation is deemed most objectively reasonable to someone in the shoes of the parties.⁶⁶ In deciding on the most reasonable objective interpretation, the actual subjective intent of either party is no longer relevant.⁶⁷ This also brings us to the fundamental difference between preformation course of dealing and trade usage, as compared to postformation course of performance.

A course of dealing between the parties or a trade usage the parties knew or should have known must be objectively reasonable.⁶⁸ However, a postformation course of performance sheds absolutely no light on what our hypothetical objectively reasonable person would have thought, because such future conduct was unknowable at the time of formation.⁶⁹ Unlike

66. See CISG, *supra* note 30, at art. 8(2) (“[S]tatements made by and other conduct of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.”).

67. See Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 303-08 (1986) (explaining that objectively manifested conduct provides a far sounder basis for contractual obligation than subjectively held intentions, unless such subjective intentions are commonly held by both parties or are known to the other party at the time of contracting); see also *Skycom Corp. v. Telstar Corp.*, 813 F.2d 810, 814-15 (7th Cir. 1987) (explaining that a determination of objective intent relies upon the parties' public or shared outward manifestations, and “does not invite a tour through [a party's] cranium, with [the party] as the guide”); Joseph M. Perillo, *The Origins of the Objective Theory of Contract Formation and Interpretation*, 69 FORDHAM L. REV. 427, 460 (2000) (stating that under objective theory, the “vantage point of the reasonable person in the position of the promisee” is the legally relevant perspective and the “parties' own [subjective] intentions on the meaning of the contract” are irrelevant).

68. The requirements for proving a usage of trade or a course of dealing focus squarely on the issue of what is objectively reasonable. See U.C.C. § 1-205(2)-(3) (2001). In effect, a trade usage or course of dealing may serve as a private dictionary used by these particular parties to supplement the ordinary lexicon found in dictionaries of more common usage. Patterson, *supra* note 43, at 847. In looking to the parties' own preformation circumstances, including a specific course of dealing or a broader usage of trade, we are most likely to arrive at an objectively verifiable intent that most closely approximates the parties' own individual (and undiscoverable) subjectively held intent. Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 862 n.90, 875-76 (1992).

69. I am unaware of any principles that would impart clairvoyance to our objective reasonable person. See Barnett, *supra* note 67, at 305 (discussing how consent analysis compares several elements of an individual's conduct to aid in determining the meaning of terms and the actual intentions of the parties, given that direct access to another individual's subjective mental state is not possible).

trade usage or a course of dealing, which shed significant light on the objective intent of the parties at the time of contracting, a course of performance is analytically irrelevant and cannot aid in interpretation when making a determination of that same objective intent.

Presumably, the interpretive relevance of a course of performance (or any subsequent conduct) is potential impeachment of the party's current assertions of contrary subjective intent. If one party can prove that the other is lying and does not truly disagree as to subjective intent, then we need not even look at the question of objective intent.⁷⁰ Where the postformation conduct consists of mutual affirmative representations of earlier subjective intent,⁷¹ the use of such conduct to interpret the parties' agreement without ever reaching the objective interpretation question seems unassailable. In such a case, it further makes sense to give this positive, direct evidence of subjective intent precedence over other forms of evidence.⁷² After all, a finding of common subjective intent, whether based on postformation conduct or otherwise, avoids the need for any objective determination, including any usage of trade or course of dealing used to make such an objective determination.

One might then reasonably ask: Why should we stop with giving postformation conduct precedence over *extrinsic* evidence of objective intent? If postformation conduct is really about finding common subjective intent, and if common subjective intent trumps *any* inquiry into objective intent,⁷³ then postformation conduct should trump any reference to the *express terms* of the parties' agreement.⁷⁴ However, Article 2 does not place postformation conduct at the very top of its interpretation hierarchy, as the common law does with mutually agreed upon subjective intent. Instead, the Code at least purports to give preference to express terms as

70. See RESTATEMENT (SECOND) OF CONTRACTS § 201(1).

71. In effect, such mutual affirmative representations would be tantamount to mutual admissions—or even a stipulation.

72. A course of performance is given precedence over a course of dealing or trade usage. U.C.C. § 2-208(2) (withdrawn 2003).

73. See *id.* (showing that written words of an agreement simply serve as a source from which we can attempt to determine objective intent).

74. While some would argue that a course of performance does in fact trump express terms, see WHITE & SUMMERS, *supra* note 18, § 3-3 (arguing that “in rare circumstances,” the course of performance “may . . . override express terms”), the Code at least purports to give priority to express terms. U.C.C. § 2-208(2) (withdrawn 2003); see also U.C.C. § 2-202(1) (2003). *Restatement (First) of Contracts* section 235(e) also deferred to express terms, allowing postformation conduct as conclusive evidence of the parties' interpretation of a term only if such an interpretation was objectively reasonable. RESTATEMENT (FIRST) OF CONTRACTS § 235(e) (1932).

the ultimate objective manifestations of the parties' intent.⁷⁵

In fact, the Code does not appear to limit the use of course of performance evidence to a preliminary determination of subjective intent. Instead, under the Code, we add together an eclectic mix of express terms, course of performance, course of dealing, trade usage, and, perhaps, additional parol evidence.⁷⁶ What we then end up with is a mix of quite dissimilar evidence, some of which is arguably relevant to subjective intent, some of which is arguably relevant to objective intent, and none of which is likely relevant to both. When you consider that we are attempting to use two analytically distinct sources of evidence (evidence of subjective intent and evidence of objective intent) that are relevant in answering two analytically distinct questions of interpretation,⁷⁷ and we are doing so by attempting to mix them all together into a single construct,⁷⁸ it is hardly surprising that courts frequently make a mess of the endeavor.⁷⁹

As stated earlier, the Code also takes the use of course of performance evidence a significant step further than the common-law doctrine, giving effect to the parties' common affirmative representations of earlier subjective intent.⁸⁰ Under the Code, silent acquiescence by the

75. Express terms are given precedence over a course of performance, as well as a course of dealing or trade usage. U.C.C. § 2-208(2) (withdrawn 2001).

76. See U.C.C. § 2-202 (2003) (allowing for "course of performance, course of dealing, or usage of trade" and sometimes allowing additional parol evidence). Section 2-202 does not expressly state whether it applies an objective or subjective theory of contract interpretation. However, aside from the inclusion of course of performance evidence relating solely to subjective intent, its structure seems entirely consistent with the objective theory.

77. See RESTATEMENT (SECOND) OF CONTRACTS §§ 201(1), 201(2)(a) (1981) (raising questions of subjective intent); *id.* § 201(2)(b) (raising questions of objective intent).

78. See U.C.C. § 2-202(1)-(1)(a) (2003) (stating that final agreements between parties "may not be contradicted by evidence of any prior agreement . . . but may be supplemented by course of performance, course of dealing or usage of trade"); U.C.C. § 2-208 (withdrawn 2001) (stating that "any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement").

79. See, e.g., *Farmers Elevator Co. of Reserve v. Anderson*, 552 P.2d 63, 65-66 (Mont. 1976) (intermittently citing both sections 1-205 and 2-208 in support of its discussion of a course of performance—not a course of dealing—and failing to make any meaningful distinctions between the use of such a course of performance as evidence of original intent, modification, or waiver of the contractual provision in question—not just the statute of frauds requirement).

80. Presumably, such common affirmative representations of subjective intent remain relevant under the Code, based on the common law supplementation of the

parties⁸¹ is deemed relevant to a determination of their earlier subjective intent.⁸² This presents two additional challenges, distinct from those presented by the analytical infirmities explained above. First, the statutory construct, while giving extraordinary significance to silent acquiescence,⁸³ provides, at best, a fundamentally ambiguous basis for its implication of subjective intent from that postformation silence. Second, the use of such evidence to a party's later disadvantage will discourage the very commercial cooperation the Code seeks to encourage as an expression of normative commercial law. The first challenge, followed by further discussion of the problems of mixing evidence of subjective and objective intent, is explored in detail below. The second challenge is introduced below and addressed in greater depth in Part IV.

B. *Revisiting Nanakuli*

The classic contracts case, *Nanakuli Paving & Rock Co. v. Shell Oil Co.*⁸⁴ provides an excellent context for our analysis. Shell Oil Company and Nanakuli Paving Rock Company entered into a long term requirements contract in 1969, in which Shell agreed to sell asphalt to Nanakuli for use in its paving business, and Nanakuli agreed to buy its asphalt from Shell and pay for the asphalt according to the terms of the

Code under section 1-103(b). See U.C.C. § 1-103(b) (2001) ("Unless displaced by the particular provisions of [the Uniform Commercial Code], the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause supplement its provisions.").

81. I use the term "silent acquiescence" as a shortened equivalent to the Code's language describing "any course of performance accepted or acquiesced in without objection." U.C.C. § 2-208(1) (withdrawn 2001).

82. Like affirmative conduct, silent postformation acquiescence cannot possibly be relevant to any prior objective intent (though, it might be relevant to subsequent modification, discussed *infra* note 138), nor can it be relevant to one party's knowledge of the other's subjective intent at the time of formation. Thus, silent postformation acquiescence must be intended to shed light on a potential common subjective intent. See *generally* RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981) (stating which party's meaning of terms prevails). This relevance of course of performance to subjective intent is not expressly stated anywhere in the Code. In fact, the combined use of course of performance, course of dealing, and trade usage under section 2-202 would seem to indicate a common application to objective intent. However, such an approach would be inconsistent with basic objective theory.

83. A course of performance is deemed the "best indication" of the parties' intent, U.C.C. § 2-208 cmt. 1 (withdrawn 2003), and is "always relevant" to determining said intent, *id.* at cmt. 2.

84. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772 (9th Cir. 1981).

agreement.⁸⁵ The written terms of the 1969 agreement provided that the price to be paid by Nanakuli was “Shell’s Posted Price at time of delivery.”⁸⁶ Thus, the plain language of the written agreement unambiguously provided that, if Shell’s “Posted Price” was increased, then Nanakuli would be required to pay the new price for any asphalt “delivered” after the price increase.⁸⁷ However, Nanakuli argued that it was entitled to “price protection” under the parties’ agreement.⁸⁸ Based on this price protection, Shell was required, after any price increase, to allow Nanakuli to purchase asphalt at the old price—either for a certain period of time or for a certain specified tonnage.⁸⁹

Shell, predictably, argued that the written price term controlled, while Nanakuli argued that its interpretation was supported by evidence of trade usage at the time of the 1969 agreement and a course of performance based on the parties’ conduct in 1970 and 1971.⁹⁰ At trial, the jury agreed with Nanakuli that the agreement required Shell to provide price protection in the event of a price increase.⁹¹ However, the trial judge set aside the jury’s verdict on Shell’s motion for judgment notwithstanding the verdict.⁹² On appeal, the court addressed, *inter alia*, the use of course of performance

85. *Id.* at 777.

86. *Id.* at 778.

87. *Id.*

88. *Id.*

89. *Id.* at n.4. Definiteness and predictability are additional casualties with many implied terms. See generally Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 866-71 (2000).

90. Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d at 778-79. Nanakuli also argued that, even if the parties’ agreement did not require price protection, commercial standards of good faith did. *Id.* at 778. As explained *infra* note 103, the case presents an interesting question with respect to the appropriate time frame for evidence of such commercial standards. However, I will limit the analysis here to the interpretation of the specific terms of the agreement.

Shell also provided Nanakuli with price protection in 1977 and 1978. *Id.* at 785. However, the court acknowledged that neither of these could constitute a course of performance of the 1969 agreement, inasmuch as they each took place under different agreements. *Id.* at 779 n.7, 785 n.17. In addition, each of these incidents of price protection took place after Nanakuli filed suit in 1976, *id.* at 777, and therefore, after Shell had already expressly stated its understanding that it was not required to provide price protection under the 1969 agreement. Assuming the later agreements were also silent on price protection, Shell’s conduct in providing it—notwithstanding its belief that such price protection was not required—would seem almost unequivocally to amount to a voluntary business decision rather than a contractual obligation. See discussion *infra* Part IV.

91. Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d at 777.

92. *Id.*

evidence as it related to the interpretation of the parties' 1969 agreement.⁹³

While this Article does not focus on trade usage, its application in this case is important to understanding the significance of the court's use of course of performance evidence. In 1969, there were only two asphalt suppliers in the Hawaiian paving trade—Shell and Chevron.⁹⁴ While Chevron routinely provided price protection,⁹⁵ Shell did not.⁹⁶ Based on a trade of suppliers limited to Shell and Chevron alone, it would have been difficult to find a sufficiently regular trade practice to justify its application to the parties' agreement.⁹⁷ Thus, the court defined the applicable "trade" more broadly and looked also at the practices of suppliers of aggregate for use in paving.⁹⁸ These aggregate suppliers regularly provided their customers with price protection.⁹⁹ Based on the combined practices of asphalt and aggregate suppliers, the court found sufficient evidence to support the jury's reliance on a usage of trade in interpreting the agreement.¹⁰⁰

If the trade usage issue had been less open to question, perhaps the course of performance issue would not have been as important. However, there was a sense here that the court knew the trade usage issue was problematic.¹⁰¹ There was a critical difference between asphalt suppliers and aggregate suppliers—asphalt was a petroleum-based product and aggregate was not.¹⁰² Thus, costs for asphalt suppliers were directly driven by the price of oil, whereas costs for aggregate suppliers were not. In fact, the court acknowledged that, in 1974, the aggregate companies could not be considered part of the same trade as the asphalt companies, because the

93. See *id.* at 779 n.7 (upholding the use of such evidence in this case despite Shell's contention that their past actions were merely a waiver of the terms of the 1969 agreement). While the court upheld the use of course of performance evidence in this case, it declined to hold that the Uniform Commercial Code allows it under normal circumstances. *Id.*

94. *Id.* at 790.

95. *Id.* at 784.

96. See *id.* at 785-86 (explaining that in its dealings with Nanakuli, although Shell previously offered price protection by providing a grace period before the price increases would go into effect, it did not always adhere to this practice).

97. See U.C.C. § 1-205(2) (2001) (requiring such regularity of observance as to justify an expectation that it applies to the transaction in question).

98. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 791-92.

99. *Id.* at 792-93.

100. *Id.* at 804-05.

101. See *id.* at 778 n.6 (denying trade usage by cement suppliers because cement was used too infrequently in asphalt paving).

102. See *id.* at 779 (defining aggregate as "crushed rock").

aggregate companies “did not labor under the same disabilities as did asphalt suppliers” at that time.¹⁰³ And yet, the court was willing to ignore a very similar fundamental difference between the two suppliers as it existed in 1969 when the parties executed their agreement.¹⁰⁴ Presumably realizing that trade usage, by itself, was at best a questionable basis for reinstating the jury’s verdict, the court went on to consider course of performance.¹⁰⁵

There was no question that Shell had provided price protection to Nanakuli when it had raised prices in 1970 and 1971.¹⁰⁶ The sole question was whether Shell was required to do so under the contract, as executed in 1969.¹⁰⁷ If so, then Shell breached the contract when it failed to provide price protection in 1974.¹⁰⁸ If not, then, at most, Shell had waived its right to raise its prices without providing price protection,¹⁰⁹ in which case its waiver was subject to retraction with reasonable notice, absent reasonable and detrimental reliance by Nanakuli.¹¹⁰ Nanakuli did not—and

103. *Id.* at 805. The disabilities referenced by the court were obviously the unpredictability of world oil prices, which were rising rapidly at that time. *See* 15 THE WORLD BOOK ENCYCLOPEDIA 349 (2002) (explaining that the price of crude oil in this country began rising significantly in 1973); *Oil Price History and Analysis*, ENERGY ECON. NEWSLETTER (WTRG Economics, London, Ark.), at <http://www.wtrg.com/prices.htm> (last modified Oct. 19, 2002) (showing that the price of oil between 1972 and 1974 quadrupled from three dollars per barrel to twelve dollars per barrel).

104. While oil prices in the United States had not yet begun to rise by 1969, political instability in the Middle East had already begun to disrupt flows to Japan and other Western nations, and the price of oil is, by nature, difficult to predict, as it is a limited resource. 15 THE WORLD BOOK ENCYCLOPEDIA, *supra* note 103, at 349.

105. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 794-96.

106. *Id.* at 778.

107. *Id.* at 777. Neither party argued modification. While modification is possible under U.C.C. § 2-209(1) (2003), with or without consideration, modification requires mutual intent. John D. Wladis, *The Contract Formation Sections of the Proposed Revisions to U.C.C. Article 2*, 54 SMU L. REV. 997, 1042 n.293 (2001) (citing JOHN J. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* 445 n.12 (2d ed. 1977)). In addition, modification may require a writing, based on the statute of frauds or a “no oral modification” clause, or both. *See infra* note 138. There do not appear to be any facts of record to support such a theory.

108. *See* U.C.C. § 2-208(1), § 2-208 cmt. 1 (withdrawn 2001) (providing for the use of a course of performance to interpret the parties’ agreement).

109. *See id.* § 2-208(3) (providing for the use of a course of performance to show waiver).

110. *See id.* § 2-209(5) (stating that reasonable notification is required). Shell wanted to retract any prior waiver because, unlike the relatively small earlier price increases for which it had provided price protection, the price increase at issue was substantial. *See Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 777.

presumably could not—argue reliance, inasmuch as Nanakuli had not changed its position in any material way from the time of the earlier price increases in 1970 and 1971 to the time of the increase at issue in 1974.¹¹¹ Thus, the resolution of the parties' dispute arguably depended on whether Shell's performance was used to show waiver or used to interpret the parties' earlier agreement.¹¹²

Under the Code, a course of performance involves multiple performances "by either party with knowledge of the nature of the performance and opportunity for objection to it"¹¹³ "[A]ny course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the [parties' earlier] agreement."¹¹⁴ The implication made here requires a couple of inferential leaps.

First, the Code only requires that the party to be charged have knowledge of the nature of the actual performance—but includes no express requirement that the party have knowledge at the time of its precise rights and obligations under the parties' agreement.¹¹⁵ Empirically, we know that many commercial parties conduct their business without reference to their actual agreement.¹¹⁶ A commercial party may also frequently act through multiple agents and employees, some of whom may not have ever read or otherwise learned of the specific terms of the

111. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 789 (describing that Nanakuli relied on its right to price protection, as the company originally understood it, and felt betrayed by Shell's deviation from its past practices, suggesting it was Shell, not Nanakuli, who had materially changed its position).

112. Although the court does not discuss the possibility, it would seem that the case could have been resolved quite easily under the doctrine of waiver. Even though, in 1974, Shell would have had a right to retract any waiver arising out of its conduct in 1970 and 1971, Shell would have been required to provide Nanakuli with "reasonable notification" that it would require strict compliance with the written price term previously waived. *See* U.C.C. § 2-209(5) (2003). With respect to the 1974 price increase, such reasonable notice would seem to have provided Nanakuli with precisely the relief it was requesting, but without using postformation conduct to interpret the earlier agreement. The real significance in choosing waiver or interpretation relates to future performance of the parties' agreement—after such reasonable notice is given. *See id.* (stating that "[a] party who has made a waiver affecting an executory portion of the contract may retract the waiver by reasonable notification" to the other party). While such future performance was not at issue in this case, it frequently is in commercial relationships.

113. U.C.C. § 2-208(1) (withdrawn 2001).

114. *Id.*

115. *See id.* (requiring only "knowledge of the nature of the performance").

116. *See* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61-63 (1963).

agreement. Therefore, any presumption that the parties know what is actually required under their original agreement is questionable, at best.

We assume that parties have read and understood the agreements they sign and, therefore, bind them at the time of formation, whether or not the parties actually know what is required under the agreement.¹¹⁷ However, the same presumption seems less appropriate or necessary in the context of a course of performance. A party about to enter into an agreement should understand that it is creating or modifying¹¹⁸ a legal relationship and can reasonably be expected to read the agreement and seek to understand it.¹¹⁹ Thus, we bind the party to the terms of the agreement, whether or not the precise details of those terms are later forgotten over the course of a long term relationship.

Once the agreement has been formed, however, the parties may relax their reference to its precise terms. The parties may refer to the original terms on occasion, to clarify a question or point of understanding, but, frequently, the agreement that was so carefully crafted and thoroughly read at an earlier time is simply filed away.¹²⁰ Few parties are likely to pull out the original agreement every time they perform or accept performance of that same agreement.¹²¹ Without any understanding of what performance is required under the agreement, a party's acceptance or acquiescence in actual performance has little, if any, logical relevance to the earlier agreement. At most, it might provide evidence of performance another party is willing to accept in the future—logically relevant to waiver or modification, but not to interpretation of the earlier agreement.

117. See Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 234 (2002) (describing judges' and legislators' continued use of the doctrine of "duty to read," which charges consumers with the duty to read and know the content of their contracts and binds them, no matter what actually took place between the merchant or lender and the consumer).

118. See *infra* note 138 (discussing the question of modification).

119. See Edith Resnick Warkentine, *Article 2 Revisions: An Opportunity to Protect Consumers and "Merchants/Consumers" Through Default Provisions*, 30 J. MARSHALL L. REV. 39, 51 (1996) (stating that when both parties are merchants with relatively equal bargaining power, they generally have the ability to negotiate and understand contract terms).

120. See Macaulay, *supra* note 116, at 61 ("Even where the parties have a detailed and carefully planned agreement which indicates what is to happen if, say, the seller fails to deliver on time, often they will never refer to the agreement but will negotiate a solution when the problem arises apparently as if there had never been any original contract.").

121. See *id.* (stating that buyers and sellers will never refer to the agreement in resolving disputes).

Perhaps a requirement of knowledge of a party's rights and obligations under the agreement is implied in the requirement that the party to be charged have an "opportunity for objection."¹²² A party without knowledge of what is required under the contract might be deemed to lack a reasonable opportunity to object. If this is supposed to be part of the inquiry, there is no indication that the *Nanakuli* court sought to determine whether Shell's representatives actually knew what was required under the 1969 agreement when they performed in 1970 and 1971.¹²³

Second, and perhaps more importantly, the Code presumes that any party accepting or acquiescing in performance must be doing so because such performance is precisely that which is required under the parties' agreement.¹²⁴ In effect, this amounts to contractually binding¹²⁵ a party through ambiguous silence—a concept rejected by the Code in other contexts.¹²⁶

C. *The Inherent Ambiguity of a Course of Performance*

In section 2-207, the Code rejected the common law mirror image rule that frequently bound parties to another's terms if they silently performed or accepted performance without having reached a mutual agreement.¹²⁷ Under the Code, a party could not be bound to a term not expressly agreed to, unless that party was a merchant, and the term was not material.¹²⁸ Under the 2003 revision to section 2-207, the approach is arguably even more restrictive. A party cannot be bound by an agreement

122. U.C.C. § 2-208(1) (withdrawn 2001).

123. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 794 (9th Cir. 1981).

124. As few as two instances of performance can give rise to this inference. *See id.* (holding that two instances of price protection established a course of performance). While former comment 4 to section 2-208 provides that a single occasion of conduct cannot give rise to a course of performance, U.C.C. § 2-208 cmt. 4 (withdrawn 2003), this comment has not been carried over to the treatment of course of performance evidence under section 1-303, U.C.C. § 1-303 (2001).

125. I emphasize here the idea of contractual obligation, as opposed to that of waiver or estoppel, the latter of which is most likely to arise through silence. *See* 28 AM. JUR. 2D *Estoppel and Waiver* § 60 (2000) (stating that "[e]stoppel may arise by silence where one is under a duty to speak or act"). Even waiver may require more than mere silence. *See id.* § 209 (stating that waiver may be implied based on a party's failure to affirmatively assert a right, but "mere silence is no waiver").

126. *See* discussion *infra* Part III.C.

127. *See* U.C.C. § 2-207(3) (withdrawn 2003) (establishing that "[c]onduct by both parties recognizes the existence of a contract") (emphasis added).

128. *Id.* § 2-207(2).

to any term not affirmatively agreed upon.¹²⁹ The reason we do not ordinarily give effect to silence as acceptance is because silence, by its nature, is inherently ambiguous.

For example, in *Nanakuli*, Shell might have provided price protection in 1970 and 1971 because its representative: (1) knew it was required under the agreement because he or she actually crafted the agreement on behalf of Shell and subjectively knew what was intended; (2) erroneously thought (for any number of reasons) it was required under the agreement; (3) had not thought at all about whether it was required, but simply provided it in furtherance of the parties' business relationship; or (4) did not believe either subjectively or objectively that it was required under the agreement, but nevertheless provided price protection in these instances in hopes of avoiding a current dispute of an issue that might or might not be subject to dispute in the future.¹³⁰ Only the first of these four possibilities justifies the inference made by the Code in using a course of performance to interpret the parties' agreement. While any of the latter three circumstances would preclude such an inference, the third and fourth are particularly problematic, as the Code approach may actually discourage commercial cooperation.¹³¹

In his 1947 General Comment on Parts II and IV of what was to become Article 2, Llewellyn recognized the ambiguity of such conduct between commercial parties,¹³² particularly "among merchants who have or expect to have continuing relations."¹³³ As posed by Llewellyn, the question raised by a course of performance was "whether such conduct represents a favor, through a unilateral waiver of a term, or a right implicit

129. See *id.* § 2-207 (2003) (including as express terms of the contract only those terms appearing in the records of both parties or "to which both parties agree"—without any distinction between merchants and nonmerchants).

130. We all exercise some form of choosing our battles—whether in business or personal relationships. In some instances of disagreement, a battle must be fought; but in others, acquiescence in the context of a minor concern might avoid having to fight the battle in the context of a major one. If so, the relationship has arguably been enhanced.

131. See discussion *infra* Part IV.A-C.

132. The Karl Llewellyn Papers, *supra* note 47, at J, IX, 2a, § 1 (noting that "it is frequently impossible to say whether a course of conduct under a written agreement interprets the parties' original meaning or represents a subsequent standing waiver of some term or terms of the agreement").

133. *Id.* at J, IX, 2a, § 10. Llewellyn discusses this in the context of acceptance "with an adjustment," despite a right to reject. *Id.* But the concept is equally applicable whether or not it involves an adjustment.

in the contract being recognized in the course of performance.”¹³⁴ Llewellyn further noted that good faith precluded turning “favors” into “unalterable rights,” and certainty demanded resolving “fair doubts” in favor of explicit terms.¹³⁵

Despite these concerns, however, Llewellyn was inexorably wedded to the realist school of contract interpretation.¹³⁶ As such, he was determined to provide for the potential use of a course of performance in interpretation.¹³⁷ Llewellyn seemingly resolved this apparent conflict by allowing that a course of performance might be relevant to interpretation, waiver, or modification,¹³⁸ but, as between its use to support interpretation or waiver, establishing an explicit preference for waiver.

In dealing with and preserving the inherently flexible nature of most

134. *Id.*; see also Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 276 (1985) (explaining the difficulty faced by courts in determining whether fundamentally ambiguous conduct amounts to *ex ante* meaning of an agreement or *ex post* waiver of that same agreement).

135. The Karl Llewellyn Papers, *supra* note 47, at J, IX, 2a, § 10.

136. See *id.* (arguing that “the evil of literal or rigid reading of commercial language . . . must be avoided”); Danzig, *supra* note 1, at 621-22 (discussing Llewellyn’s realist perspective). See generally TWINING, *supra* note 44.

137. The Karl Llewellyn Papers, *supra* note 47, at J, IX, 2a, § 10.

138. Modification is rarely part of this conflict because it is much less likely to arise out of potentially ambiguous conduct. While modification does not require consideration under U.C.C. section 2-209(1), it does require clear and unequivocal intent. *Am. Suzuki Motor Corp. v. Bill Kummer, Inc.*, 65 F.3d 1381, 1386 (7th Cir. 1995). A course of performance giving rise to waiver, on the other hand, may arise out of much more dubious or ambiguous expressions of assent. See E. ALLAN FARNSWORTH, *CONTRACTS* § 8.5 (3d ed. 1999) (“Conduct such as continuing performance with knowledge that the condition has not occurred might be questionable as the manifestation needed for a modification but sufficient for waiver.”) (citation omitted).

A modification under Article 2 must also typically be in writing. First, it must comply with the statute of frauds. U.C.C. § 2-209(3) (2003). While the original writing might be said to satisfy this requirement, a separate writing would certainly be required for any material modification. FARNSWORTH, *supra* § 6.2. Second, many agreements contain no-oral-modification clauses, which are enforceable under section 2-209(2). See U.C.C. § 2-209(2) (“An agreement in a signed record which excludes modification or rescission except by a signed record cannot be otherwise modified or rescinded, but except as between merchants such a requirement in a form supplied by the merchant must be separately signed by the other party.”). A course of performance rarely involves a written explanation of its significance (hence, the ambiguity). Thus, the characterization of ambiguous conduct is almost always a choice between evidence of waiver or interpretation of prior intent.

commercial relationships, Llewellyn noted that it was important that the parties had a right to strictly enforce the literal language of their original agreement—notwithstanding any subsequent course of performance—as long as the other party received due notice of such a decision.¹³⁹ Thus, “[w]hen there is doubt as to the meaning and effect of the parties’ actions in the course of performance, [the Code] favors that interpretation which stresses the concept of waiver of a term,” rather than use of the course of performance in interpretation.¹⁴⁰ By favoring the doctrine of waiver, good-faith cooperative postformation conduct and the parties’ expectations under the original agreement are both protected, “while flexibility is preserved, not only in the direction of leeway (by action and acquiescence) but also in the direction of tightening up (by due notice given).”¹⁴¹

Llewellyn’s desired preference for waiver was ultimately expressed in comment 3 to section 2-208.¹⁴² However, it has been given remarkably little effect by courts addressing course of performance evidence.¹⁴³ *Nanakuli*

139. The Karl Llewellyn Papers, *supra* note 47, J, IX, 2a, § 10.

140. *Id.*

141. *Id.*

142. See U.C.C. § 2-208 cmt. 3 (withdrawn 2001) (“Where it is difficult to determine whether a particular act merely sheds light on the meaning of the agreement or represents a waiver of a term of the agreement, the preference is in favor of ‘waiver’ whenever such construction, plus the application of the provisions on the reinstatement of rights waived (see Section 2-209), is needed to preserve the flexible character of commercial contracts and to prevent surprise or other hardship.”). The comment could have perhaps been better drafted. For example, the idea of an act *merely* shedding light on the meaning of the agreement, versus the application of waiver does not make it obvious that it is intended to protect the ability of the performing party to retract any effect of its performance, as long as proper notice is given. However, the text of the comment, when coupled with Llewellyn’s own notes, makes such intent clear.

The comments were, in large part, written by the original drafters of the Code and are, therefore, important as aids in its interpretation. HAWKLAND & MILLER, *supra* note 51, § 1-102:10. Courts generally have given great weight to these comments, particularly in view of the express purpose of the Code to promote uniformity in the law. *Id.* However, not all courts have always followed them. *Id.* In the case of a direct conflict between the Code text and comments, the text controls. *Id.*

143. I have been able to find only eight courts that have addressed the preference for waiver expressed in comment 3 (amongst a vastly greater number of cases addressing course of performance evidence under section 2-208). *E.g.*, *Paragon Res., Inc. v. Nat’l Fuel Gas Distribution Corp.*, 695 F.2d 991, 998 (5th Cir. 1983); *Westinghouse Credit Corp. v. Shelton*, 645 F.2d 869, 872-73 (10th Cir. 1981); *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 794 (9th Cir. 1981); *T.J. Stevenson & Co. v. 81,193 Bags of Flour*, 629 F.2d 338, 365 (5th Cir. 1980); *Cent. Ill. Pub. Serv. Co. v. Atlas Minerals, Inc.*, 965 F. Supp. 1162, 1173 (C.D. Ill. 1997); *SG Coal Co. v. Lujan*, 808

presents a classic example of a court's failure to give meaningful effect to the preference intended by Llewellyn and an excellent starting point for a review of the cases citing comment 3.

Shell argued that its conduct in 1970 and 1971 at most amounted to waiver and based its argument on comment 3.¹⁴⁴ The court cited and quoted the applicable comment, but then opined that "[t]he preference for waiver only applies, however, where acts are ambiguous."¹⁴⁵ Here, the court deemed it within the province of the jury to determine whether the acts were ambiguous and, therefore, affirmed the jury's use of the acts to interpret the parties' 1969 agreement.¹⁴⁶ Arguably, this analysis failed to give any meaningful effect to Llewellyn's intended preference for waiver.

The *Nanakuli* opinion contains no indication that the jury received an instruction based on the preference for waiver expressed in comment 3 to section 2-208.¹⁴⁷ If it did not, then comment 3 was given no effect at all. However, even if an appropriate jury instruction is given, there remains the question of whether a jury should decide the issue at all. The facts relating to the issue in *Nanakuli* are again instructive.

In deciding the issue of whether Shell's conduct should be construed as waiver or evidence of original intent, the court pointed to two factual circumstances. First, the court pointed out that Blee, a Shell representative involved in negotiating the 1969 agreement, had written of the need to "bargain" with Nanakuli over any price protection relating to the 1970 price increase.¹⁴⁸ The court deemed this an indication that Nanakuli had some sort of price protection under the 1969 agreement.¹⁴⁹ While this

F. Supp. 1258, 1262-63 (W.D. Va. 1992); *Wagner Excelllo Foods, Inc. v. Fearn Int'l, Inc.*, 601 N.E.2d 956, 962 (Ill. Ct. App. 1992); *Shurtleff v. Jay Tuft & Co.*, 622 P.2d 1168, 1175 (Utah 1980). Most of these courts, arguably, failed to give comment 3 its intended effect. While a few may have implicitly favored waiver, as provided in comment 3, none explicitly did so. See *infra* Part IV.E (discussing the various approaches taken by these courts).

144. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 794.

145. *Id.*

146. *Id.*

147. While there is no indication of such a jury instruction in *Nanakuli*, at least one court citing comment 3 did take this approach. See *Shurtleff v. Jay Tuft & Co.*, 622 P.2d at 1174-75 (affirming the use of a jury instruction stating a preference for waiver based on the language of comment 3). In view of the importance of the issue and the thoroughness of the opinion, it would seem that the appellate court would have made reference to any such instruction had one been given.

148. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 785, 794.

149. *Id.* at 794.

might be one reasonable inference, another reasonable inference would be that any price protection would involve separate “bargaining” because it was not part of the original agreement. In fact, I suspect that most reasonable commercial parties would expect that performance to be “bargained for” is not the subject of a current legal obligation. Even if reasonable minds might differ, the statement is, at most, ambiguous.

Secondly, the court pointed to the fact that Shell had provided price protection in 1977 and 1978 under a later agreement and indicated that these facts might have further supported the jury’s decision.¹⁵⁰ However, the court earlier acknowledged that neither of these could constitute a course of performance of the 1969 agreement, inasmuch as they each took place under different agreements.¹⁵¹ Moreover, each of these incidents of price protection took place after Nanakuli filed suit in 1976.¹⁵² By that time, Shell had already expressly stated its understanding that it was not required to provide price protection under the 1969 agreement.¹⁵³ Assuming the later agreements were also silent on price protection, Shell’s conduct in providing it—notwithstanding its belief that such price protection was not required—would seem almost unequivocally to amount to a voluntary business decision rather than a contractual obligation.¹⁵⁴ Again, at most, the conduct is ambiguous.

These two sets of facts relied upon by the court in *Nanakuli* illustrate precisely the problem recognized by Llewellyn. Absent a clear statement of intent by the parties, almost all postformation conduct is likely to be ambiguous. This was the reason for the inclusion of comment 3.¹⁵⁵ Unless the preference is applied by the court as a matter of construction,¹⁵⁶ there is

150. *Id.* at n.31.

151. *Id.* at 779 n.8.

152. *Id.* at 777, 779 n.8.

153. *Id.* at 786.

154. The alleged price protection under the 1977 and 1978 agreements was somewhat different than that actually sought by Nanakuli. While Nanakuli argued that Shell was required to hold its pre-increase price for all asphalt tonnage committed by Nanakuli at the time of the increase, the actions by Shell in 1977 and 1978 amounted to nothing more than reasonable notice prior to a price increase. *Id.* at 777, 794 n.31.

155. See *TWINING*, *supra* note 44, at 330 (stating that the comments serve many functions, including narrowing doubt and furthering uniformity of interpretation).

156. Unlike contract interpretation, which may go to the jury under some circumstances, contract construction is always a matter of law for the court. 3 CORBIN ON CONTRACTS § 534 (1960); FARNSWORTH, *supra* note 138, § 7.7; JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 86 (4th ed. 2001); see Mark P. Gergen, *The Jury’s Role in Deciding Normative Issues in the American Common Law*, 68 FORDHAM L. REV. 407, 445-48 (1999) (explaining the jury’s extremely limited role in contract

no assurance that it will be given effect, and there is a significant possibility that good faith cooperative conduct will be punished and ultimately discouraged—just as Llewellyn feared.¹⁵⁷ The structure of section 2-202 and the hierarchy expressed in section 2-208 also support the idea that comment 3 should be given effect by the court as a matter of legal construction.¹⁵⁸

D. *A Problem of Circularity*

Express terms are supposed to be given priority over any course of performance, any course of dealing, or trade usage,¹⁵⁹ all which may only be used as an aid in interpretation to the extent it is consistent with express terms.¹⁶⁰ The court decides the question of whether any course of performance, course of dealing, or trade usage may reasonably be construed as consistent with express terms, or, to the contrary, must be deemed inconsistent and, therefore, inadmissible as evidence of contractual intent.¹⁶¹

Thus, a course of performance may only be used for *interpretation* to the extent it is *consistent* with express terms.¹⁶² On the other hand, a course of performance may only be used as evidence of *waiver*, if it is deemed *inconsistent* with the express terms.¹⁶³ Thus, we have an obvious problem of circularity in deciding whether a course of performance is to be used as evidence of waiver or interpretation.

If one decides whether a given course of performance is evidence of contractual intent or evidence of waiver, then one has effectively decided the question of consistency with respect to any express terms.¹⁶⁴ On the

construction); Patterson, *supra* note 43, at 836-38 (explaining that construction “is within the exclusive province of the judge”).

157. See *infra* Part IV.A-C (exploring this issue more fully).

158. U.C.C. § 2-202 (2003); U.C.C. § 2-208(2) (withdrawn 2001).

159. U.C.C. § 2-208(2).

160. U.C.C. § 2-202.

161. FARNSWORTH, *supra* note 138, § 7.13 (explaining that evidence of a course of performance, course of dealing, or trade usage is only admitted for use by the fact finder in determining intent if consistent with the express terms); see *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 795 (9th Cir. 1981) (“Performance, usages, and prior dealings are important enough to be admitted always, even for a final and complete agreement; only if they cannot be reasonably reconciled with the express terms of the contract are they not binding on the parties.”).

162. FARNSWORTH, *supra* note 138, § 7.13.

163. U.C.C. § 2-208(3) (withdrawn 2001).

164. See *supra* text accompanying note 162.

other hand, if one decides the issue of consistency with respect to express terms, then one has effectively decided whether a given course of performance is evidence of contractual intent or evidence of waiver.¹⁶⁵ Inasmuch as the court decides the issue of consistency, and one decision will necessarily drive the other, the court should also be charged with giving effect to the preference for waiver expressed in comment 3 to section 2-208.¹⁶⁶

E. A Question for the Court

Finally, the issue of whether the conduct constituting a course of performance is ambiguous is quite similar to the question of whether a contract term is ambiguous. The latter is clearly the province of the court,¹⁶⁷ and so should be the former. However, unlike interpretation of a term held to be ambiguous by the court, which does go to the jury, the interpretation of ambiguous post-formation conduct should not go to the jury. It should be held to be waiver by the court, as a matter of law, consistent with the preference expressed in comment 3.

By deferring to the jury on the question of whether the conduct was ambiguous, the *Nanakuli* court failed to give effect to comment 3. At least two other courts citing and discussing comment 3 have expressly followed *Nanakuli* and, thereby, also failed to give proper effect to the comment's preference for waiver.¹⁶⁸ Other courts discussing comment 3 may or may not have given it effect, but, if they did give it effect, either did so without saying or by employing other approaches.

165. See *supra* text accompanying note 163.

166. U.C.C. § 2-208 cmt. 3 (withdrawn 2001). Theoretically, a court could decide that a course of performance could be consistent with express terms (but could also be inconsistent, thus giving rise to a jury question on this issue), and the jury could still decide to the contrary, finding it inconsistent. As such, a jury could still go either way on the question of waiver of interpretation. However, such a jury would nevertheless be faced with the same problem of circularity, further reducing the likelihood of giving proper effect to comment 3.

167. See, e.g., *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 645-46 (Cal. 1968) (describing how the court must consider evidence); *W.W.W. Assocs., Inc. v. Giancontieri*, 566 N.E.2d 639, 642 (N.Y. 1990) (finding that "ambigu[ity] is a question of law to be resolved by the courts") (citation omitted); see also FARNSWORTH, *supra* note 138, § 7.12 (explaining that the question of ambiguity is always one for the court, whether approached from the formalist "four corners" perspective or the realist "all the facts and circumstances" perspective).

168. See *Paragon Res., Inc. v. Nat'l Fuel Gas Distribution Corp.*, 695 F.2d 991, 997-98 (5th Cir. 1983) (following *Nanakuli*, not giving proper effect to preference for waiver); *SG Coal Co. v. Lujan*, 808 F. Supp. 1258, 1262-63 (W.D. Va. 1992) (same).

In some cases, courts have deemed a course of performance irrelevant for purposes of interpretation by deciding that the express terms were unambiguous.¹⁶⁹ This is obviously wrong under section 2-202, which does not require ambiguity as a predicate to the use of course of performance evidence,¹⁷⁰ even if, in some cases, it may result in giving waiver its appropriate preference. In other cases, courts may have engaged in the circular reasoning discussed above, simply deciding that a given course of performance is inconsistent with the express terms and may, therefore, only be evidence of a possible waiver.¹⁷¹ While this is not necessarily improper under the Code, it would seem more straightforward and effective to simply follow comment 3, particularly considering the malleability of the concept of consistency.¹⁷²

169. *E.g.*, Cent. Ill. Pub. Serv. Co. v. Atlas Minerals, Inc., 965 F. Supp. 1162, 1175 (C.D. Ill. 1997). Having quoted and thoughtfully discussed comment 3 earlier, *id.* at 1173, the court seemed to use an improper analysis based on lack of ambiguity to reach the same result and deem the conduct to be a waiver, if anything, *id.* at 1175. In addition, in *Global Octanes Texas, L.P. v. BP Exploration & Oil, Inc.*, the Judge Patrick Higginbotham, the same judge who had followed *Nanakuli* in *Paragon Resources*, employed this erroneous reasoning to avoid using a course of performance to interpret the parties' prior agreement. *Global Octanes Tex., L.P. v. B.P. Exploration & Oil, Inc.*, 154 F.3d 518, 522 (5th Cir. 1998).

170. *See* U.C.C. § 2-202 cmt. 1(c) (2003) (explicitly rejecting any requirement of ambiguity as a condition precedent to the use of a course of performance as an aid in interpretation).

171. *See, e.g.*, *Wagner Excello Foods, Inc. v. Fearn Int'l, Inc.*, 601 N.E.2d 956, 962 (Ill. Ct. App. 1992) ("The issue before us is not the meaning of the [express terms of the contract]; the issue is whether the [express terms of the contract] were waived."). In some cases, courts simply do not consider using the course of performance at issue to interpret the agreement, instead limiting the analysis to waiver. *E.g.*, *Westinghouse Credit Corp. v. Shelton*, 645 F.2d 869, 872-73 (10th Cir. 1981) (discussing whether plaintiff waived its "right to strictly enforce the contract's terms"); *T.J. Stevenson & Co. v. 81,193 Bags of Flour*, 629 F.2d 338, 365-66 (5th Cir. 1980) (examining whether parties' course of performance subsequent to the contract's execution operated as a "waiver of specific contractual provisions"). It is unclear whether the parties failed to make the argument, or whether the court gave direct effect to comment 3 or indirect effect by deciding the conduct was inconsistent with the express terms.

In another case, the court refused to allow consideration of a course of performance, as inconsistent with the express terms, but did so only after using a course of dealing to interpret the express terms. *KN Energy, Inc. v. Great W. Sugar Co.*, 698 P.2d 769, 778-79 (Colo. 1985). While arguably inconsistent with the hierarchy giving a course of performance precedence over a course of dealing, the opinion is quite well reasoned and shows the logical propriety of using a course of dealing over a course of performance in objective contract interpretation. *See id.* (using course of dealing to interpret express terms).

172. Remarkably, the opinion addressing course of performance evidence

One might argue that the preference for waiver, as advocated here, would effectively swallow the rule providing for the use of a course of performance to interpret the parties' agreement, as provided for in section 2-208(1). Admittedly, it is difficult to reconcile an effective application of comment 3 with a fair reading of section 2-208(1)—especially if one gives serious consideration to comment 1, which states that the parties' actions under an agreement are the “best indication” of what they intended under the original agreement.¹⁷³ I believe this apparent contradiction reflects Llewellyn's conflicting concerns.¹⁷⁴

In the case of course of performance evidence, Llewellyn's concerns that lead us to favor waiver may be of greater import than those encouraging us to look beyond the parties' writings in search of their agreement. If this approach swallows the rule, then perhaps that is appropriate.¹⁷⁵ On the other hand, there may yet be room for the use of course of performance evidence for purposes of interpretation in the limited case of unambiguous affirmative statements by the parties, much like the treatment of subsequent conduct under pre-Code common law or under the CISG.¹⁷⁶

F. *Mixing Inferences of Intent in Nanakuli*

In conclusion of Part III of this Article, we return briefly to our earlier analysis of the use of course of performance evidence of earlier subjective intent in conjunction with evidence of objective intent at the time of formation. In effect, the *Nanakuli* court combined arguably insufficient trade usage evidence of objective intent with arguably improper course of performance evidence of subjective intent to provide what it determined to be a fully sufficient basis to reinstate the jury's verdict.¹⁷⁷ There is no basic analytical construct to support this. Intent may

under Article 2 that is arguably the most consistent with comment 3 to section 2-208 did not cite comment 3 at all, but did include a good summary of its rationale. See *Sethness-Greenleaf, Inc. v. Green River Corp.*, 65 F.3d 64, 67 (7th Cir. 1995) (explaining that a party's repeated forbearance from asserting its rights does not evidence a future right to such forbearance, but is subject to retraction with reasonable notice, lest the forbearing party be encouraged to avoid such forbearance and the receiving party lose the benefit of such lenience).

173. U.C.C. § 2-208 cmt. 1 (withdrawn 2001).

174. See discussion *supra* Part III.C.

175. See discussion *infra* Parts IV-VI.

176. See *supra* Part III.A-C.

177. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 804-05 (9th Cir. 1981).

be found based on shared subjective intent¹⁷⁸ or it may be found based on reasonable objective intent.¹⁷⁹ However, there is no logical analytical basis for combining them.¹⁸⁰

Shell stated that it did not subjectively intend to be bound to provide price protection.¹⁸¹ Nanakuli stated a contrary subjective intent.¹⁸² Unless the jury had a sound basis to decide that one of the parties was lying about its subjective intent, then the only basis for deciding between the parties' respective claims of subjective intent was by deciding which was more objectively reasonable—at the time of contracting. An inherently ambiguous course of performance is hardly a sound basis to fully discount a party's stated intent and, instead, find a contrary subjective intent.

This brings us back to objective intent. A subsequent course of performance has no logical relevance at the time of contracting, so we are left to rely exclusively on trade usage—the trade of two parties who engaged in inconsistent practices supplying petroleum-based paving products in Hawaii. Without a sound basis to support a jury finding of price protection based on either subjective or objective contract theory, the court effectively combined both to create something else.¹⁸³ The problem was that this “something else” had no logical or doctrinal underpinnings in basic contract law.

Perhaps, one might argue that this distinction between subjective and objective evidence is artificially formal, and the combination of the two is perfectly appropriate in search of the parties' bargain in fact. However, even if one accepts an analytical construct combining course of performance evidence with that used in the search for objective contract intent, there are substantial policy reasons not to use course of

178. See RESTATEMENT (SECOND) OF CONTRACTS § 201(1) (1981) (stating that when both parties attach the same meaning to a term, that meaning prevails).

179. See *id.* § 201(2)(b) (stating that in the event of disagreement, when only one party's meaning is objectively reasonable, that party's meaning prevails).

180. In effect, this combination of subjective and objective evidence amounts to a revision of *Restatement (Second) of Contracts* section 201(2)(b), so as to provide for selection of one party's claimed subjective intent based on some undivided combination of: (1) what a reasonable person would have thought at the time of contracting; and (2) who the fact finder thinks is more likely to be telling the truth about subjective intent. The effect of such an approach would fully undermine objective contract theory.

181. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d at 787-89.

182. *Id.*

183. Admittedly, the court was simply following the mandate of section 2-202. However, the analytical construct is no less flawed.

performance evidence in this manner.

IV. THE USE OF COURSE OF PERFORMANCE EVIDENCE TO INTERPRET THE PARTIES' PRIOR AGREEMENT DISCOURAGES COOPERATIVE COMMERCIAL BEHAVIOR

A. *Cooperation, Dispute Resolution, and Course of Performance Evidence*

Llewellyn sought in the Code to incorporate normative commercial practices into the commercial body of law, thus turning immanent commercial norms into immanent commercial law.¹⁸⁴ In so doing, Llewellyn hoped that normative, good-faith commercial behavior would be reinforced by the application of the Code to control commercial behavior and resolve commercial disputes.¹⁸⁵ In giving effect to a course of performance by the parties to an agreement, however, Llewellyn recognized certain inherent conflicts in achieving his goal. These conflicts and their potential effect on commercial behavior, first raised in Part III, are further explored here.

In her seminal 1996 article, Lisa Bernstein argues that the Code's attempt to "discover and apply immanent business norms in deciding cases," would "fundamentally alter the very reality [it] sought to reflect, and would do so in ways that would have undesirable effects on commercial relationships and would undermine the Code's own stated goals"¹⁸⁶ Bernstein argues against the use of course of dealing, trade usage, and course of performance evidence on this basis,¹⁸⁷ and appears to

184. See TWINING, *supra* note 44, at 303-07 (articulating Llewellyn's objectives and values in drafting the Code).

185. See U.C.C. § 1-103(a)(2) (2001) (stating that one of the purposes of the Code is "to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties"); *id.* § 1-103 cmt. 1 (2001) ("The Uniform Commercial Code is drawn to provide flexibility so that . . . it will provide its own machinery for expansion of commercial practices.").

186. Bernstein, *Merchant Law*, *supra* note 2, at 1768-69; See also Bernstein, *Questionable Empirical Basis*, *supra* note 2, at 746-76 (explaining generally this fallacy in the Code's incorporation strategy). Commercial parties would be much less likely to engage in cooperative divergence from the express terms of their agreement if such divergence would be likely to change the nature of their legal obligation. Bernstein, *Questionable Empirical Basis*, *supra* note 2, at 769.

187. See Bernstein, *Merchant Law*, *supra* note 2, at 1796-1815. Interestingly, Bernstein argues that the drafters of the Code failed to recognize the inherent flaws in this approach. *Id.* at 1769. However, Llewellyn arguably did recognize the very same issues raised by Bernstein—as they relate to the use of course of performance evidence in interpretation. See discussion *supra* Part III.C.

argue against the use of the latter in all three of its forms: interpretation, waiver, and modification.¹⁸⁸ Predictably, Bernstein's provocative theory has drawn numerous critical responses.¹⁸⁹ However, her arguments, at least as specifically applied to course of performance used for interpretation, stand up remarkably well.¹⁹⁰

It has long been established that the nature of a commercial relationship may frequently differ in significant ways from that contained in the parties' formal written memorial of their agreement.¹⁹¹ Thus, a course of performance may differ from that called for in the written agreement for a variety of reasons.¹⁹²

A party engaged in a continuing commercial relationship is likely to make conscious efforts to develop and preserve that relationship. Bernstein calls these "relationship-preserving norms" or "RPNs."¹⁹³ RPNs

I also believe that the fundamental difference between preformation course of dealing and trade usage—as compared to postformation course of performance evidence—mandates the use of the former and the exclusion of the latter under an objective theory of contract interpretation. See discussion *supra* Part III.A.

188. Bernstein, *Merchant Law*, *supra* note 2, at 1809.

189. See, e.g., Ben-Shahar, *supra* note 1, at 782 (taking a critical approach different from Bernstein's); Jason Scott Johnston, *Should the Law Ignore Commercial Norms? A Comment on the Bernstein Conjecture and Its Relevance for Contract Law Theory and Reform*, 99 MICH. L. REV. 1791, 1791 (2001) (focusing on the Bernstein conjecture and the social and market context in which it is likely to hold); Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian Macneil and Lisa Bernstein*, 94 NW. U. L. REV. 775, 775 (2000) (discussing "Bernstein's challenge to conventional ideas about custom and performance of contracts"); John E. Murray, Jr., *Contract Theories and the Rise of Neoformalism*, 71 FORDHAM L. REV. 869, 891-907 (2002) (critiquing the neoformalism approach espoused by Bernstein); William J. Woodward, Jr., *Neoformalism in a Real World of Forms*, 2001 WIS. L. REV. 971, 973 (2001) (stating that Bernstein's "normative recommendations have a 'Back to the Future' quality to them").

190. In fact, little of the critique of Bernstein's work has focused on course of performance evidence used for interpretation. See, e.g., Johnston, *supra* note 189, at 1791 (focusing his critique on the concepts of reasonableness and good faith); Macaulay, *supra* note 189, at 784 (focusing his critique on trade usage); Murray, *supra* note 189, at 819-927 (focusing his critique on neoformalism, generally); Woodward, *supra* note 189, at 972 (focusing his critique on neoformalism as it applies to form contracts).

191. See Macaulay, *supra* note 189, at 55 (finding that businesspersons frequently fail to plan their agreements and rarely use legal remedies to modify the agreements or settle disputes); see also Bernstein, *Merchant Law*, *supra* note 2, at 1787-88 (offering a more recent corroboration of Macaulay's observations).

192. See discussion *supra* Part III.C.

193. Bernstein, *Merchant Law*, *supra* note 2, at 1796.

may include “favors,” as described by Llewellyn,¹⁹⁴ or cooperative resolution of minor disputes, so as to preserve the ongoing relationship.¹⁹⁵ Some commercial relationships may never move beyond the stage of RPNs, continuing indefinitely or ending on the best of terms. However, other relationships will conclude in some form of end-game dispute.¹⁹⁶ When this happens, a party may reasonably expect to be able to rely upon its formal written agreement. Under these circumstances, the parties would be engaged in what Bernstein calls “end-game norms” or “EGNs.”¹⁹⁷

The problem occurs when RPNs are used by courts in resolving disputes in ways that undermine the rights of the parties’ respective EGNs contained in the written agreement. This use of a course of performance, as evidence of the meaning of the parties’ original agreement—including any EGNs—is likely to discourage the very cooperative conduct it is intended to promote and reinforce. A simple cooperative commercial “favor” may, both retroactively and prospectively, become a binding commitment. The cooperative resolution of actual and potential dispute in one context may dictate the later resolution of a similar dispute in a very different context, in which the stakes are much different.¹⁹⁸

We have all likely faced the issue of choosing our battles in

194. See discussion *supra* Part III.C.

195. Bernstein, *Merchant Law*, *supra* note 2, at 1796.

196. *Id.*

197. *Id.*

198. Ben-Shahar argues that the “rigidity effect” noted by Bernstein will be, effectively, counterbalanced by the “flexibility effect” intended by the Code’s drafters. Ben-Shahar, *supra* note 1, at 794-96. If so, then the Code’s use of course of performance evidence, as well as course of dealing or usage of trade, will not have the effect of discouraging cooperative behavior, as predicted by Bernstein. Bernstein, *Merchant Law*, *supra* note 2, at 1812. However, Ben-Shahar assumes a constant cost of performance that is non-compliant with the express terms. Ben-Shahar, *supra* note 12, at 797-99. However, if the cost of noncompliant performance varies, then the balance is lost.

When the cost of noncompliant performance associated with end-game dispute resolution is greater than the cost of noncompliant performance associated with RPNs, then the party allowing the earlier noncompliance is harmed. *Id.* The “rigidity effect” becomes greater than the “flexibility effect,” and the party will be discouraged from engaging in such cooperation in future relationships (or discouraged in the current relationship if the potential for such an outcome is anticipated). See *id.* at 797-800 (discussing possibilities under the “rigidity effect” and the “flexibility effect”). This change in the cost of noncompliant performance is precisely what happened in *Nanakuli*, in which the two earlier price increases were relatively small and the one leading to the end-game dispute was quite large. *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 777, 785 (9th Cir. 1981).

relationships. Whether in the context of a commercial, social, or work relationship, we find a common reality. A person that fights every battle to which he or she has a right or remedy will have few, if any, successful relationships. Instead, we learn (albeit at differing paces) to choose whether, and sometimes when, to fight or not to fight any given battle or contest, or any given dispute over our perceived rights or entitlements. Few would disagree with the premise that such exercises in discretion are more likely to develop and preserve relationships than to detract from or destroy them. However, a party to a relationship is much more likely to fight each and every battle if its silent acquiescence is likely to redefine the original nature of the relationship itself.

B. *Preserving One's Rights*

Under the Code, a contracting party need not actually fight each and every battle in order to preserve its rights, but it must clearly and unequivocally object to the other party's performance in order to preserve such rights.¹⁹⁹ Such an objection must be explicit and is most likely to be effective if it includes words such as "without prejudice" or "under protest."²⁰⁰ Any party attempting to soften the tone of such a preservation of rights, in hopes of continuing its cooperative attempts to resolve a potential dispute, does so at its own peril. The case that follows is instructive by way of example.

In *Lancaster Glass Corp. v. Philips ECG, Inc.*,²⁰¹ Philips was a buyer of electronic glass bulbs from Lancaster, which Philips, in turn, converted into cathode ray tubes for use in video display monitors.²⁰² The engineering drawings for the bulbs provided for a diagonal taper angle at certain points on the bulb of one-and-one-half degrees,²⁰³ and Lancaster, in its written agreement with Philips, promised that all "bulbs to be delivered under [the] order would 'conform to all specifications, drawings, [and] descriptions furnished, specified or adopted' by Philips."²⁰⁴

199. U.C.C. § 2-208(1) (withdrawn 2001) (explaining that "any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement").

200. See U.C.C. § 1-308(a) (2001) ("A party that, with explicit reservation of rights, performs or promises performance or assents to performance in a manner demanded or offered by the other party does not thereby prejudice the rights reserved. Such words as 'without prejudice,' 'under protest,' or the like are sufficient.").

201. *Lancaster Glass Corp. v. Philips ECG, Inc.*, 835 F.2d 652 (6th Cir. 1987).

202. *Id.* at 653.

203. *Id.* at 655.

204. *Id.* at 658.

During the performance of the agreement, which involved multiple shipments of bulbs, Philips discovered that the angles on some of the bulbs exceeded the specified one-and-one-half degrees, and that the variance appeared to be causing problems with T-banding the bulbs—a critical element of Philips’ manufacturing process.²⁰⁵ In August, 1980, Philips raised the T-band slippage problem with Lancaster, and at a meeting representatives of both companies agreed that the variance from the specifications was causing the problem.²⁰⁶ Thereafter, Lancaster proposed to continue shipping Philips its existing bulbs, despite the variance from specifications, but to change its molds and thereby meet specifications for future bulb production under the agreement.²⁰⁷ Because Philips failed to expressly object to Lancaster’s proposal at that time, the court deemed its acquiescence a course of performance and used that course of performance as an aid in implying that the bulb specifications allowed for sufficient tolerances that the goods supplied by Lancaster conformed to the parties’ agreement.²⁰⁸

The key point for our discussion here is that Philips unquestionably put Lancaster on notice of the problem with the bulbs and the potential dispute as to whether the bulbs conformed to the parties’ agreement. However, Philips did so in the context of trying to solve the problem with Lancaster in a cooperative manner, rather than formally stating it was only discussing the problem with Lancaster “under protest” and “without prejudice” to its right to demand conforming bulbs in the future. This ultimately worked to Philips’ detriment.

Thus, a party attempting to protect its contractual rights must provide the other contracting party with explicit notice, including formal language of a pending dispute, of every potential issue that arises and might occur again under an agreement, or risk changing the original deal by way of reinterpretation.²⁰⁹ Such an explicit formal statement of the existence of a

205. *Id.* at 655.

206. *Id.* at 655-56.

207. *Id.* at 656.

208. *Id.* at 659-60.

209. I find that this concept hits home for many by looking at it in the context of a spousal (or other similar) relationship. In many such relationships, the two people may implicitly or explicitly each take on certain regular duties or obligations. For example, perhaps A cooks and B cleans. If A asks B to cook on a particular evening, B might very well want to do so in furtherance of the relationship—even if B has no interest in cooking on a regular basis. On the other hand, suppose B inadvertently takes on that duty absent a clearly registered objection. Knowing this, B might say: “Sure, I will cook this evening, but only ‘under protest’ and ‘without prejudice’ to my

potential dispute is likely to invite the other party to stake out its own formal position and, thereby, raise the level of the dispute—perhaps even elevating a potential dispute to an actual one.²¹⁰ Disputes become much more difficult to avoid (or even resolve) as the parties raise the rhetoric and become increasingly invested in their respective positions.²¹¹

C. Following by Analogy the Wisdom of Federal Rule of Evidence 408

Federal Rule of Evidence 408 provides for cooperative settlement under circumstances that are, in some ways, analogous. Pursuant to this rule, “[e]vidence of . . . [conduct or statements made] in compromising or attempting to compromise a claim which was disputed . . . is not admissible to prove liability for or invalidity of the claim”²¹² The purpose of the Rule is to promote cooperative and creative settlement efforts, unfettered by each of the parties trying to protect its respective formal litigation position, in the event such settlement negotiations should fail.²¹³ No one would argue that conduct during settlement negotiations is without any possible logical relevance. In fact, such conduct might be helpful in deciding the merits of the parties’ case. Nevertheless, the Rule deems the evidence legally irrelevant, because any conduct is just as likely to be motivated by a desire for peace as by a belief in the weakness of one’s case.²¹⁴ This is precisely the same ambiguity that Karl Llewellyn recognized in dealing with a course of performance under an agreement, and course of performance evidence should be similarly barred as evidence of the meaning of the parties’ prior agreement. Even if silent acquiescence has some minimal logical relevance, our desire to promote cooperative dispute avoidance or resolution should lead us to deem such evidence legally irrelevant as an aid in interpretation.

right to refuse in the future.” I think we can all say with some level of certainty that such conduct would not be useful in developing and preserving the relationship. See Bernstein, *Merchant Law*, *supra* note 2, at 1813 (noting additional difficulties with the requirement of objection).

210. For example, one can easily imagine the performing party bringing an action for declaratory judgment at this stage.

211. See ROGER FISHER & WILLIAM URY, *GETTING TO YES* 3-4 (Bruce Patton ed., 2d ed. 1991) (describing negative implications of positional bargaining).

212. FED. R. EVID. 408.

213. See FED. R. EVID. 408 advisory committee’s note (explaining that the Rule is based on two grounds: (1) the evidence is irrelevant—as it is likely motivated by a desire to resolve the dispute—as any concession with respect to the merits of the other party’s position; and (2) “promotion of the public policy favoring the compromise and settlement of disputes”).

214. *Id.*

D. *The Problem of Reliance*

Lisa Bernstein makes many of the same or similar points in her article on merchant law.²¹⁵ Based on these observations, Bernstein appears to argue against the use of course of performance evidence for any purpose, including waiver or modification.²¹⁶ However, there is a problem with precluding the use of a course of performance for waiver.²¹⁷ While cooperative dispute resolution is likely encouraged by the preclusion of such evidence, a party that is unaware of the potential or pending dispute may be caught unaware. It is just such a party that may reasonably rely on a course of performance to its potential detriment, thereby justifiably invoking the doctrine of waiver.

Where both parties are aware of the potential dispute and choose not to pursue it at the time, neither party is likely to detrimentally rely on the other's conduct. If it did, such reliance would almost certainly be unreasonable and would, therefore, fail as a basis for enforcement.²¹⁸ In other cases, a party may not be aware of the potential dispute, but may not change its position in reliance. In each of these cases, any waiver arising out of a course of performance would be fully subject to retraction with reasonable notice.²¹⁹ However, where one party is absolutely unaware of the potential dispute and relies upon the other's conduct in deciding its own course of action, then any waiver arising out of silent acquiescence

215. See generally Bernstein, *Merchant Law*, *supra* note 2.

216. *Id.* at 1809.

217. A course of performance might or might not be appropriate to show modification, depending on whether or not there was sufficient evidence that the parties each intended to modify their agreement. While consideration is not required under section 2-209(1), U.C.C. § 2-209(1) (2003), nothing in Article 2 abrogates the requirement of mutual intent. Arguments based on unwritten modifications are also much less likely to arise in the context of long-term commercial agreements, as most such agreements include "no-oral-modification" clauses, which are routinely enforced under section 2-209(2).

218. See WHITE & SUMMERS, *supra* note 18, at 57 (explaining that "reasonable" reliance may give rise to a waiver); see also *Wis. Knife Works v. Nat'l Metal Crafters*, 781 F.2d 1280, 1287 (7th Cir. 1986). The notion of reasonable reliance is also implied in the language of section 2-209(5), where retraction is allowed unless it "would be *unjust* in view of a material change of position in reliance on the waiver." U.C.C. § 2-209(5) (2003) (emphasis added). Retraction of a waiver in the face of unreasonable reliance would not give rise to an injustice and would not, therefore, be precluded.

219. See U.C.C. § 2-209(5) (2003) (providing for a retraction of a waiver by reasonable notification).

may not be subject to retraction, to whatever extent justice requires.²²⁰ This use of a course of performance as a potential waiver is explored more fully in Part V.

E. Contracting Around Course of Performance Evidence

There is one other problem with the use of course of performance evidence in interpretation, which is arguably much more difficult to overcome than it is with course of dealing or trade usage evidence. Inasmuch as any course of dealing or trade usage must, by definition, exist prior to formation of the agreement at issue, the parties have a reasonable opportunity to negate such evidence at the time of formation.²²¹ However, at the time of contracting, the parties are unlikely to have any idea what kinds of course of performance issues may arise later. Courts have typically required a high degree of specificity in avoiding any course of dealing or trade usage.²²² If the same degree of specificity were required for a course of performance, a general disclaimer of its use in interpretation might not be effective.²²³

It is also unclear whether an express, but general, disclaimer of course

220. See *id.* (disallowing retraction if it “would be unjust in view of a material change of position in reliance on the waiver”).

221. But see Bernstein, *Merchant Law*, *supra* note 2, at 1810-11 (seemingly arguing that RPNs may preclude this). I do not necessarily agree that RPNs play the same role at the time of formation. While the parties may have an ongoing relationship, the time of execution of a new formal, written agreement would seem to be somewhat different, perhaps as a sort of “game restart” in which each party has the opportunity to revisit existing issues or, effectively, ratify past practices by failing to disavow them in the formal agreement. The nature of the formal contracting process thus provides an additional basis upon which I would distinguish between the use of course of dealing and trade usage on one hand and course of performance evidence on the other.

222. See, e.g., *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3, 9 (4th Cir. 1971) (holding that “a finding of ambiguity is not necessary for the admission of extrinsic evidence about the usage of the trade and the parties’ course of dealing”).

223. But see *Moini v. Hewes*, 763 P.2d 414, 416 (Or. Ct. App. 1988) (refusing to allow jury consideration of an agreement by the parties to substitute the composition of initial deliveries for an exhibit omitted from the formal agreement, because the formal agreement expressly disavowed the use of course of performance evidence to interpret its meaning). In view of the fact that the parties affirmatively agreed to the substitution, this seems like far stronger evidence of intent than silent acquiescence, and I suspect that many courts would not have reached the same result on these facts. However, the case points out the potential problems with any attempt to preempt the use of course of performance evidence under any and all circumstances, as compared with a legal standard avoiding only the use of silent acquiescence to prove prior intent.

of performance evidence would be enforced without looking at the course of performance itself as evidence of intent. While the Code provides for variation by agreement,²²⁴ it further points out that any such variation must be found in the agreement as a whole—including any course of dealing, trade usage, and course of performance.²²⁵ Any drafter of an agreement might reasonably fear that the addition of a clause disclaiming course of performance evidence would only add to, rather than reduce, uncertainty under the agreement. Thus, a party concerned about a prejudicial reinterpretation of its earlier agreement based on a cooperative course of performance may have very little opportunity to prospectively avoid the problem through careful drafting.

Even if we might reasonably find that a course of performance is logically relevant to the question of subjective intent, and even if it were appropriate to combine such evidence with that of objective intent in deciding the meaning of the parties' agreement, there remain strong policy reasons for treating any course of performance as legally irrelevant. Moreover, we can instead consider any course of performance in terms of potential waiver. In so doing, we avoid most of the pitfalls of using a course of performance to find intent, while protecting both of the parties against unfair surprise.

V. WAIVER REPRESENTS A BETTER APPLICATION OF COURSE OF PERFORMANCE EVIDENCE IN PROTECTING THE REASONABLE EXPECTATIONS OF ALL PARTIES

A. *Waiver as a Balanced Approach*

While much of the rationale supporting a preference for waiver in the use of course of performance evidence has been introduced in the preceding material, a review and further development is appropriate here. If we really want to encourage the greatest degree of flexible cooperation between the parties to an agreement, the best approach would be to bar all evidence of their postformation conduct in deciding their respective rights and duties. While such conduct would obviously be relevant to determining breach and, if appropriate, damages, it would have no role in defining the relationship.

In fact, this approach would be quite similar to that taken under

224. U.C.C. § 1-302(a) (2001).

225. See U.C.C. § 1-302 cmt. 1 (2001) (stating that agreement, as used in the section, “includes . . . course of dealing, trade usage, and course of performance”).

Federal Rule of Evidence 408.²²⁶ In order to encourage maximum cooperative behavior in settlement negotiations, we bar evidence of conduct during such negotiations in defining the rights and responsibilities of the parties to be adjudicated.²²⁷ There is, however, for our purposes, a critical difference between settlement negotiations and performance of parties to an ongoing agreement. In the former, the parties always know of their dispute and its contours, whereas, in the latter, one party may or may not be aware that the other is performing or acquiescing in performance as a matter of voluntary cooperative behavior rather than a matter of perceived contractual obligation. It is this naïve party, who may reasonably be misled by the other's course of performance, who we seek to protect through the doctrine of waiver.

Thus, allowing the use of course of performance evidence—while simultaneously limiting that use to waiver—strikes a balance between promoting cooperative flexible behavior and protecting the innocent party that may reasonably and detrimentally rely on such behavior.²²⁸ A party engaging in voluntary cooperative behavior, beyond that required by the parties' agreement, may, in the absence of reasonable reliance, retract any legal effect of such conduct, provided that reasonable notice is given.²²⁹

As noted by Llewellyn, one of the key principles under the Code is the prevention of unfair surprise.²³⁰ An appropriate application of the principles of waiver to any postformation silent acquiescence, as well as a bar on the use of such evidence to interpret the parties' prior agreement, protects the interests of both parties. The performing party avoids the surprise of changing standards of performance, if that party has reasonably and detrimentally relied on the other party's acquiescence to such performance.²³¹ In any case, the performing party is entitled to reasonable

226. See discussion *supra* Part IV.C.

227. FED. R. EVID. 408.

228. See FARNSWORTH, *supra* note 138, § 8.5 (explaining that waiver appears to permit more flexibility in dealing with the conduct of the parties at the performance stage than the use of a course of performance to support interpretation or modification).

229. *Id.*

230. See discussion *supra* Part III.C.; see also U.C.C. § 2-302 cmt. 1 (2003) (explaining unconscionability as based on avoidance of oppression and unfair surprise).

231. See U.C.C. § 2-209(5) (2003) ("A party that has made a waiver affecting an executory portion of the contract may retract the waiver by reasonable notification received by the other party that strict performance will be required of any term waived, unless the retraction would be unjust in view of a material change of position in reliance on the waiver.").

notice before any previously accepted standards of performance are changed in deference to the parties' original agreement.²³²

On the other hand, the acquiescing party is protected from the unfair surprise of discovering that its cooperative or inattentive behavior has suddenly changed the meaning of its earlier agreement so carefully negotiated and executed.²³³ First, to be effective, a waiver requires "the intentional relinquishment of a known right."²³⁴ Therefore, unlike a course of performance used for interpretation, acquiescence of a party without knowledge of its rights under the original agreement is unlikely to give rise to waiver. Second, a party concerned with protecting its original rights can do so by retraction with reasonable notice, absent reliance.²³⁵ In fact, reliance may be further avoided by clear notice of the potential dispute, but short of the formal objection called for under section 1-308(a).

The application of the doctrine of waiver is also less likely to unfairly surprise either party inasmuch as it has been a part of our common law for a much longer time than the Code's novel use of silent acquiescence in support of interpretation. Arguably, the provisions regarding waiver under the Code²³⁶ simply restate the common law of waiver.²³⁷ While the Code provisions relating to waiver are helpful in integrating this concept with the

232. *Id.*

233. As discussed in Part III.C, former section 2-208(1) required "knowledge of the nature of the performance" itself, but not necessarily knowledge of the previously agreed upon standards for performance. U.C.C. § 2-208(1) (withdrawn 2001).

234. *Sethness-Greenleaf, Inc. v. Green River Corp.*, 65 F.3d 64, 67 (7th Cir. 1995). *But see* FARNSWORTH, *supra* note 138, § 8.5 (describing this meaning as misleading because what is involved is not a relinquishment of a known right, but the "excuse of the nonoccurrence of or a delay in the occurrence of a condition of a duty"). While a party's intent to waive may be implied by reference to facts of which the party knew or had reason to know, a factual finding of intent is an absolute prerequisite to a finding of waiver. MURRAY, *supra* note 156, § 111 & nn.596, 607.

235. U.C.C. § 2-209(5) (2003). With the potential for retraction of a waiver, the balance between the "rigidity effect" and "flexibility effect" suggested by Ben-Shahar is much more likely. *See* Ben-Shahar, *supra* note 1, at 784 ("The flexibility effect and the rigidity effect arising from doctrines like course of performance and waiver generally balance out."). If the cost of noncompliant performance is likely to increase significantly, then the affected party need only provide reasonable notice of its retraction.

236. U.C.C. § 2-208(3) (withdrawn 2001); U.C.C. § 2-209(4)-(5) (2003).

237. *See* RESTATEMENT (SECOND) OF CONTRACTS § 84 (1981) (providing for waiver and, with respect to executory obligations, retraction with reasonable notice, absent reasonable and detrimental reliance).

rest of the Code,²³⁸ they should be unlikely to unfairly surprise any commercial party.

B. Further Benefits of the Doctrine of Waiver

The application of waiver is also entirely consistent with an objective theory of interpretation. In the same manner the parties' outward manifestations are interpreted from the viewpoint of an objectively reasonable person in the shoes of the parties, so too do we approach waiver. Waiver only arises through a course of performance when a reasonable person viewing the other parties' outward manifestations of conduct would expect such conduct to continue.²³⁹ Any reliance, so as to preclude retraction, must also be objectively reasonable under the circumstances.²⁴⁰ In each case, the party's outward manifestations are employed as an objective basis for predicting future intended conduct, rather than as a basis to imply previously unstated subjective intent.

With waiver, we can also give consistent effect to a course of performance of any party to an agreement—whether one of the original parties or a successor in interest to one of the original parties. When used to interpret the original agreement, a course of performance of a successor in interest would appear to have absolutely no logical relevance in determining either the objective or subjective intent of the original parties.²⁴¹ Thus, a single agreement might be subject to differing interpretations, depending on the status of the performing party. However, when evaluated under the doctrine of waiver, a course of performance of a successor carries the same potential implications as if performed by one of the original parties, and such a course of performance can be given the same effect.²⁴²

238. *But see* Wis. Knife Works v. Nat'l Metal Crafters, 781 F.2d 1280 (7th Cir. 1986) (including a vigorous disagreement over the interpretation and application of section 2-209 between Judge Posner, writing for the majority, and Judge Easterbrook in dissent); *see also* FARNSWORTH, *supra* note 138, § 7.6 (suggesting that perhaps both majority and dissent missed the mark).

239. HAWKLAND & MILLER, *supra* note 51, § 2-209:5 n.2.

240. *See, e.g.,* Pepsi-Cola Co. v. Steak 'N Shake, Inc., 981 F. Supp. 1149, 1155 (S.D. Ind. 1997) (holding that "reliance must be *reasonable*"); *see also* HAWKLAND & MILLER, *supra* note 51, § 2-209:5; WHITE & SUMMERS, *supra* note 18, § 1.6, at 57.

241. *But see* Comment, *Evaluating the Conduct of Successors in the Interpretation of Contract Terms: Practical Construction and Judicial Method*, 57 IOWA L. REV. 215, 220-21 (1971) (suggesting that a course of performance of a successor is a perfectly appropriate source of intent under the original agreement).

242. *Id.* at 223-25 (recognizing the straightforward use of a course of

In applying the doctrine of waiver, courts are dealing with traditional tools based on objective manifestations of conduct and traditional commonlaw notions of estoppel. The commonlaw doctrine of waiver is long established and broadly applied by our courts in a variety of legal fields.²⁴³ Thus, a court's level of experience and competence in dealing with waiver should be greater than its experience and competence in attempting to give meaning to ambiguous silent acquiescence to whatever extent such conduct may (or may not) relate to prior contractual intent.

The doctrine also provides a court with a greater range of outcomes. For example, waiver might: (1) absent reasonable reliance, require minimal notice under the circumstances; (2) absent reasonable reliance, require substantial notice under the circumstances; (3) with reasonable reliance, give rise to only partial detriment and only partial relief; or (4) with reasonable reliance, give rise to complete detriment and complete relief. If used to interpret the parties' earlier agreement, a court might likely be limited to a grant of "all or nothing" relief. While the flexibility inherent in the application of waiver might give rise to some uncertainty in the rights of the parties, this uncertainty would seem to be much less than that arising under a doctrine that revisits the parties' original contractual intent.

Thus far, we have focused on course of performance evidence of contractual intent under Article 2, and this Article has argued that a preference for waiver under section 2-208, as a matter of law, is appropriate for all of the reasons discussed above. However, the potential uses of course of performance evidence under the Uniform Commercial Code are about to expand significantly under section 1-303 of revised Article 1,²⁴⁴ and it is within the rest of the Code that we find even greater reasons for declining any invitation to use a course of performance to interpret the parties' prior agreement. Once we leave the narrow confines of Article 2, all of the arguments in support of a meaningful preference for waiver are significantly magnified.

performance as evidence of waiver or modification to either an original or successor party).

243. See Jessica Wilen Berg, *Understanding Waiver*, 40 HOUS. L. REV. 281, 282-83 (2003) (listing areas of law to which waiver has been applied).

244. See U.C.C. § 1-303 (2001) (defining what constitutes course of performance); *id.* § 1-102 (stating that Article 1 applies to the other articles of the Code).

VI. A MEANINGFUL PREFERENCE FOR WAIVER TAKES ON INCREASING IMPORTANCE WHEN COURSE OF PERFORMANCE IS APPLIED BROADLY THROUGHOUT THE CODE UNDER SECTION 1-303

A. *The Use of Course of Performance Evidence Outside of Article 2*

When Article 1 was revised, the treatment of course of performance evidence was moved from former section 2-208 to new section 1-303, where it now accompanies course of dealing and trade usage evidence, which were formerly found in section 1-205.²⁴⁵ While this change may, at first blush, seem obvious and unimportant, its effects could indeed be profound and perhaps unintended, particularly if courts were to use course of performance evidence throughout the Code in a manner similar to that applied in *Nanakuli* and other Article 2 cases.²⁴⁶ However, before looking at the application of new section 1-303, it is useful to review prior court decisions considering the possible application of former section 2-208 beyond the boundaries of Article 2.

A substantial majority of the courts explicitly addressing the issue have strictly confined section 2-208 to Article 2 transactions involving sales of goods.²⁴⁷ Most courts reaching this result have relied on the language of section 2-102 limiting the scope of the provisions of Article 2 to "transactions in goods."²⁴⁸ However, a few courts have applied section 2-

245. Compare U.C.C. § 2-208 (withdrawn 2001), and U.C.C. § 1-205 (1952), with U.C.C. § 1-303 (2001).

246. See discussion *supra* Part III.B.

247. See, e.g., *Banca del Sempione v. Suriel Fin., N.V.*, 852 F. Supp. 417, 428 n.5 (D. Md. 1994), *rev'd on other grounds*, *Sempione v. Provident Bank*, 75 F.3d 951 (4th Cir. 1996) (holding section 2-208 inapplicable to a letter of credit transaction governed by Article 5); *United Am. State Bank & Trust Co. v. Wild West Chrysler Plymouth, Inc.*, 561 P.2d 792, 795 (Kan. 1977) (holding section 2-208 inapplicable to chattel paper governed by Article 9); *Solar Motors, Inc. v. First Nat'l Bank*, 537 N.W.2d 527, 538 (Neb. Ct. App. 1995) (holding section 2-208 inapplicable to a promissory note governed by Article 3); *Cox v. Bancoklahoma Agri-Service Corp.*, 641 S.W.2d 400, 404 (Tex. Ct. App. 1982) (holding section 2-208 inapplicable to a security interest governed by Article 9); *Schaller v. Marine Nat'l Bank*, 388 N.W.2d 645, 650 (Wis. Ct. App. 1986) (holding section 2-208 inapplicable to a relationship between a bank and its customer governed by Article 4); see also *Ex parte Coussement*, 412 So. 2d 783, 786 (Ala. 1982) (refusing under Article 3 to consider conduct under the note in question, because a course of dealing under section 1-205 is limited to conduct under prior agreements).

248. U.C.C. § 2-102 (2003); see, e.g., *Cox v. Bancoklahoma Agri-Service Corp.*, 641 S.W.2d at 404 (citing the statutory language explaining that the provisions of Article 2 are expressly inapplicable to transactions intended as security interests).

208 to Code transactions outside the scope of Article 2—some after thoughtful analysis,²⁴⁹ and some without taking note of the issue at all.²⁵⁰

Courts that have actually considered the issue and found section 2-208 broadly applicable typically rely on the broad definition of “agreement” contained in Article 1.²⁵¹ Inasmuch as an “agreement” includes any relevant course of performance, such a course of performance must be applicable, broadly, throughout the Code.²⁵² Another court applied section 2-208 to chattel paper governed by Article 9, because the underlying transaction involved goods.²⁵³ While I think each of these analyses is incorrect,²⁵⁴ these courts arguably reached the right result inasmuch as they were each using a course of performance as evidence of waiver. Even if section 2-208 were not applicable, the Code provides for supplementation of common law concepts under section 1-103,²⁵⁵ which unquestionably applies to all code provisions.²⁵⁶ The application of the

249. *Westinghouse Credit Corp. v. Shelton*, 645 F.2d 869, 872 n.3 (10th Cir. 1981) (stating that chattel paper governed by Article 9 was also governed by Article 2 inasmuch as the transaction involved good in part); *Farmers State Bank v. Farmland Foods, Inc.*, 402 N.W.2d 277, 282 (Neb. 1987) (relying on section 1-201(3) to apply section 2-208 to an Article 9 transaction); *Nat'l Livestock Credit Corp. v. Schultz*, 653 P.2d 1243, 1246-47 (Okla. Ct. App. 1982) (relying on the same logic as the *Farmers State Bank* court).

250. *Tillquist v. Ford Motor Credit Co.*, 714 F. Supp. 607, 611-12 (D. Conn. 1989) (recognizing the applicability of waiver under section 2-208 to an Article 9 transaction); *Colo. State Bank v. Hoffner*, 701 P.2d 151, 153 (Colo. Ct. App. 1985) (citing section 2-208 in support of its use under Article 9 of what it called “course of dealing” evidence, but what appears from the facts to be a course of performance).

251. *See, e.g., Westinghouse Credit Corp. v. Shelton*, 645 F.2d at 872 n.3 (concluding that terms defined in Article 1 are “automatically made a part of each article in the Code”).

252. *See* U.C.C. § 1-201(3) (2001) (defining agreement to include any course of dealing or trade usage, as formerly provided in section 1-205, and any course of performance, as formerly provided in section 2-208); *see, e.g., Farmers State Bank v. Farmland Foods, Inc.*, 402 N.W.2d at 282 (relying on section 1-201(3) to apply section 2-208 to an Article 9 transaction); *Nat'l Livestock Credit Corp. v. Schultz*, 653 P.2d at 1246-47 (relying on the same logic as the *Farmers State Bank* court); *see also* PEB COMMENTARY, *supra* note 53, at 2-4.

253. *Westinghouse Credit Corp. v. Shelton*, 645 F.2d at 873.

254. *See* discussion *supra* note 53.

255. U.C.C. § 1-103 (2001).

256. *Id.* § 1-102; *see, e.g., Farmers State Bank v. Farmland Foods, Inc.*, 402 N.W.2d at 282 (in addition to its application of section 2-208, also supporting the applicability of common waiver under Article 9 based on supplementation of the Code under section 1-103); *Nat'l Livestock Credit Corp. v. Schultz*, 653 P.2d at 1246-47 (relying on the same logic as the *Farmers State Bank* court); *see also* *Moe v. John Deere*

doctrine of waiver throughout the Code requires nothing more than a straightforward application of section 1-103 to the common law of waiver.

I was unable, however, to locate a single case in which the court applied section 2-208 outside the scope of Article 2 and, thereby, used a course of performance to interpret the parties' prior agreement. Instead, each court that was willing to look at a course of performance as relevant to the parties' dispute considered only the possibility of waiver. The reasons for the court's failure to consider the course of performance for purposes of interpretation were not always entirely clear, but some inferences may be reasonably made.

Some courts state that the express terms are clear,²⁵⁷ apparently deciding that this lack of ambiguity, along with a likely merger clause, mandates exclusion for purposes of interpretation under the common law plain meaning and parol evidence rules.²⁵⁸ While this may be correct under the common law,²⁵⁹ this approach seems entirely inconsistent with the definition of agreement under section 1-201(3),²⁶⁰ which would always look to a course of performance in interpreting the parties' agreement, irrespective of whether the terms are clear.²⁶¹

Other courts have considered the course of performance inconsistent with the express terms and therefore irrelevant to the meaning of the

Co., 516 N.W.2d 332, 337 (S.D. 1994) (relying on section 1-103 to apply common law estoppel to repeated acceptance of late payments in a secured transaction governed by Article 9).

257. *Westinghouse Credit Corp. v. Shelton*, 645 F.2d at 873; *Farmers State Bank v. Farmland Foods, Inc.*, 402 N.W.2d at 281-82.

258. Presumably, the common law parol evidence and plain meaning rules would be applicable through section 1-103(b), which provides for supplementation of the common law to the extent it is not displaced by the Code's provisions. U.C.C. § 1-103(b) (2001).

259. This might depend on the court's approach to the parol evidence and plain meaning rules, which are subject to a wide variety of application, from a relatively strict "four corners" view to a broad "all the facts and circumstances" view. MURRAY, *supra* note 156, § 86.

260. See U.C.C. § 1-201(3) (2001) (defining the parties' agreement in terms of their course of dealing, trade usage, and course of performance, as well as express terms, and without any apparent requirement of ambiguity in those express terms). The definition of agreement in section 1-201(3), combined with the provisions of section 1-303, arguably mandates precisely the same approach to course of dealing, trade usage, and course of performance as is found in section 2-202(a). In effect, a course of performance would always be admissible to prove the meaning of an agreement unless inconsistent with express terms.

261. *Id.*

agreement.²⁶² This would not change under the language of section 1-303, which continues to give greatest deference to express terms.²⁶³ However, if the question of consistency were addressed throughout the Code in a manner similar to that in which it is addressed under Article 2, this could lead to significantly more instances of the use of a course of performance for interpretation.

In other cases, there is simply no indication that either party argued that a course of performance should be used for interpretation.²⁶⁴ Perhaps the parties argued only waiver because a waiver argument could be supported under the common law, as well as by an obviously debatable argument based on the application of section 2-208 beyond Article 2. With revised section 1-303(a), however, litigants are unlikely to feel so constrained.

Whatever the reason for the past limitations on the use of course of performance evidence outside of Article 2, the language of section 1-303(a) is certainly not so limited,²⁶⁵ nor does the language of section 1-201(3) provide for any limitations on the use of a course of performance to interpret the parties' agreement—irrespective of the agreement's lack of ambiguity, absent reference to such a course of performance.²⁶⁶ Moreover,

262. See, e.g., *Livestock Credit Corp. v. Schultz*, 653 P.2d at 1246-47 (holding that the terms of a cattle security agreement designed for the lender's protection were waived by the creditor's long-term course of conduct inconsistent with the protective provisions).

263. U.C.C. § 1-303(e) (2001).

264. See, e.g., *Tillquist v. Ford Motor Credit Co.*, 714 F. Supp. 607, 611-612 (D. Conn. 1989) (noting the parties' arguments but not mentioning course of performance as one of them); *Colo. State Bank v. Hoffner*, 701 P.2d 151, 153 (Colo. Ct. App. 1985) (same).

265. The language of 1-303(a) reads:

(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.

U.C.C. § 1-303(a)(1)-(2) (2001); see *id.* § 1-102 (stating that Article 1 applies throughout the Code).

266. See *supra* note 260 and accompanying text.

comment 3 to former section 2-208 has no counterpart in the comments to section 1-303, so there is no expression of a preference for waiver.²⁶⁷ Nor is comment 4 carried forward to section 1-303,²⁶⁸ inviting argument that a single instance of silent acquiescence may be used to interpret the parties' agreement. Thus, there is significant potential for the use of course of performance in deciding intent throughout the Code. In considering such a potential application, *Nanakuli* provides a useful point of reference.

B. Potential New Uses of Course of Performance Evidence

A course of performance might be relevant in determining a creditor's rights pertaining to default and acceleration pursuant to the terms of a negotiable note governed by Article 3. One can easily imagine a creditor that repeatedly accepts late payments under a note, but eventually tires of such late payments and decides to declare a default and demand immediate payment in full under the express terms of the note.²⁶⁹ The

267. See generally U.C.C. § 1-303 cmts. (2001). Interestingly, comment 1 to section 2-208, which describes the parties' actions as the "best indication" of their prior intent, U.C.C. § 2-208 cmt. 1 (withdrawn 2001), and comment 2 to section 2-208, which states that a course of performance "is always relevant to determine the meaning of the agreement," U.C.C. § 2-208 cmt. 2 (withdrawn 2001), also were omitted. See generally U.C.C. § 1-303 cmts. (2001). On the other hand, these have each been cited and given effect by such a sufficiently large number of courts that their guidance is likely to be transferred to applications of section 1-303.

It is not clear why comment 3 to section 2-208 was dropped from new section 1-303. One might infer that the drafters intentionally abandoned the former preference for waiver. However, I believe a more reasonable explanation is that the drafters simply dropped all of the relevant comments from former section 2-208, assuming that the now substantial body of case law would offer the same sort of guidance originally provided by the comments. As discussed in Part III.E., this is arguably a very poor assumption with respect to comment 3.

268. See generally U.C.C. § 1-303 cmts. (2001).

269. A similar issue arose in *J.R. Hale Contracting Co. v. United New Mexico Bank*, 799 P.2d 581 (N.M. 1990). In that case, the creditor in question had frequently accepted late payments on prior notes, but the alleged default on the note in question had arisen with respect to the first payment. *Id.* at 583-84. The court discussed potential waiver based on postformation conduct and, in doing so, pointed out that section 2-208 was limited to Article 2, but that its principles were consistent with the broader common law of waiver. *Id.* at 587-88. However, the court pointed out that all of the relevant conduct in this case occurred prior to the note in question. *Id.* at 586-87. One might, therefore, have expected the court to treat this conduct as a course of dealing under section 1-205(1); however, the court refused to do so because it believed the conduct to be inconsistent with the express terms. *Id.* at 587. Instead, the court engaged in a rather convoluted application of "waiver by estoppel" so as to find the creditor liable for misleading the debtor with respect to the instant agreement, based

debtor may then argue that the creditor's repeated acceptance, without objection, of payments on the note is evidence that the parties never intended that these prior circumstances would constitute a default.

Perhaps the "true" agreement, including the parties' course of performance, included a grace period before any default occurred, or perhaps a notice and right to cure was required before any default occurred. Such terms appear no more inconsistent with an express right to declare a default upon late payment than the price protection at issue in *Nanakuli* did when compared with the express payment terms in that agreement,²⁷⁰ nor would such predicates to default be any less amorphous than the poorly defined price protection given effect in *Nanakuli*.²⁷¹

Moreover, the debtor might argue that, as in *Nanakuli*, the present representatives of the creditor simply do not understand the "true" agreement, because they were not around when the note was executed, its terms were negotiated, and past late payments were excused.²⁷² While an advocate of the realist school of contract interpretation might applaud this result, as between the original parties, things become a bit more complicated when we add the potential for negotiation of such a note to other holders,²⁷³ including holders in due course.²⁷⁴

In order to promote negotiability, a transferee/holder of a promissory note is typically allowed to rely, for the most part, on that which is actually written within the four corners of the note itself.²⁷⁵ Under certain

on its conduct under a prior agreement. *Id.* at 588-89. While this court was inclined to construe consistency very narrowly, we have obviously seen a very different approach under Article 2.

270. See *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 778 (9th Cir. 1981) (stating that the written contract provided for "Shell's Posted Price at time of delivery").

271. See *id.* at n.4 (noting that price protection might have been based on specific tonnage or a specific time).

272. See *id.* at 788 (explaining that none of Shell's representatives present at the time of the disputed price increase had any understanding of the parties' prior conduct or of the agreement beyond the printed contract and concluding that, therefore, these representatives simply did not know the actual terms of the agreement).

273. See U.C.C. § 3-201(a) (2002) ("Negotiation" means a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes its holder.").

274. See *id.* § 3-302 (addressing holders in due course).

275. See *id.* § 3-104 (defining "negotiable instrument"); see also STEPHEN C. VELTRI, *THE ABCS OF THE UCC, ARTICLES 3 AND 4* 8-9 (1997) (stating that a person can examine the terms of an instrument to determine whether it is negotiable, but it

circumstances, a transferee/holder may also be a holder in due course or, in effect, a “super plaintiff”²⁷⁶ who is not subject to most defenses that might be raised by an obligor (here the debtor) under the common law of assignment.²⁷⁷ This raises the obvious question of how the use of course of performance evidence might affect the rights of a holder in due course under Article 3. The drafters of Article 3 appear to have anticipated the issue with respect to the use of course of performance to show waiver or modification; however, the question of interpretation is not so clear.

Section 3-117 provides that any modification of a negotiable instrument or any separate agreement affecting its enforceability constitutes a “defense” to the payment obligation.²⁷⁸ This is significant because such a “defense,” as the term is used in Article 3, would not affect the rights of a holder in due course.²⁷⁹ However, section 3-117 is limited by its language to separate, or collateral, agreements, thus allowing a holder in due course to avoid only the effect of a modification based on a course of performance.²⁸⁰

With the revision of Article 1, the drafters appear to have addressed waivers, as applied to holders in due course. The comments on changes from former law under section 1-303 explain that “a course of performance that might otherwise establish a defense to the obligation of a party to a negotiable instrument is not available as a defense against a holder in due course who took the instrument without notice of that course of performance.”²⁸¹ A waiver would unquestionably amount to a defense, as the term is used in Article 3.²⁸² Thus, the comment clarifies that a waiver based on a course of performance would not affect the rights of a holder in due course.

It is much less clear that the meaning of the terms of the agreement would amount to a defense. Suppose, for example, that a holder in due

must meet the requirements of section 3-104).

276. WHITE & SUMMERS, *supra* note 18, § 14-1.

277. See U.C.C. § 3-305 (listing defenses to enforcement of obligations); see also WHITE & SUMMERS, *supra* note 18, § 14-1 (providing an overview of remedies under the Code).

278. U.C.C. § 3-117.

279. *Id.* § 3-305(a)(2), (b).

280. See *id.* § 3-117 (explaining that an “instrument may be modified, supplemented, or nullified by a separate agreement” and further defining such action as a defense).

281. U.C.C. § 1-303, cmt. (2001).

282. See, e.g., *Sunbelt Sav., F.S.B. v. Cashin Constr. Co.*, 737 F. Supp. 41, 42 (E.D. Tex. 1990) (listing waiver as a defense to default on a promissory note).

course demanded payment of \$10,000 by the maker. If the maker refused to pay by pointing out that the terms of the note only called for a payment of \$500, we certainly would not call that a defense that could not be asserted against a holder in due course. Instead, the meaning of the agreement, in this case the note, serves to define the basic rights of the parties, subject to any potential separate defenses. It would seem, therefore, that a course of performance of a holder²⁸³ of a note can directly affect the rights of a holder in due course under Article 3, provided that such a course of performance is used as evidence of the meaning of the original note itself. Of course, this is entirely inconsistent with the entire concept of negotiable instruments under Article 3. However, it appears to be the statutory rule under new section 1-303(a) of the Code.

Perhaps courts will find a way to avoid the use of any course of performance as evidence of intent when applied to enforcement by a holder in due course. However, this would effectively mean that the terms of a note would have a different meaning if transferred. While the rules of negotiable instruments under Article 3 have always raised the possibility that a defense of an obligor might be lost through transfer, it seems more significant to say to an obligor that the actual terms of a note might change upon transfer. Whatever the courts decide to do with this apparent dilemma may well lead to uncertainty under Article 3—which would certainly have an undesirable effect on negotiability.

Another interesting potential use of course of performance evidence arises under Article 4 between a bank and its deposit customer. In *Schaller v. Marine National Bank of Neenah*,²⁸⁴ the bank had, over a seven-year period, honored overdrafts on a customer's account thirty-six times.²⁸⁵ In some of these instances the bank contacted the customer to ask if a deposit was forthcoming, but, in others, the bank was silent as it simply covered the

283. Another issue arises with respect to whether a course of performance of a holder other than the original payee may be relevant to the meaning of a note. Section 1-303(a) speaks of conduct by the "parties" to an agreement, which would seemingly include transferee/holders of a negotiable instrument. U.C.C. § 1-303(a). On the other hand, the postformation conduct of a transferee/holder does not even carry with it the minimal relevance of conduct by an original party. See discussion *supra* Part III.A. (explaining that a course of performance is, at most, relevant to the subjective intent of the performing party). After all, the transferee's conduct cannot be deemed relevant to the subjective intent of the original parties when the transferee was not one of them. See discussion *supra* Part IV.B. (addressing the analytical difficulty in using a course of performance of a successor as evidence of original intent and the preferable treatment of such a course of performance under the doctrine of waiver).

284. *Schaller v. Marine Nat'l Bank*, 388 N.W.2d 645 (Wis. Ct. App. 1986).

285. *Id.* at 647.

overdraft.²⁸⁶ Predictably, the bank eventually refused one day to pay an overdraft by the customer and, instead, dishonored the customer's check.²⁸⁷ The customer sued, claiming breach of contract.²⁸⁸

The bank argued that it had no contractual obligation to pay overdrafts and that, absent such an obligation, it was free to dishonor any check for which its customer did not have adequate funds on deposit.²⁸⁹ The customer argued that the bank had an implied contractual obligation to pay such overdrafts—an obligation that arose, *inter alia*, from the parties' course of performance of their deposit agreement.²⁹⁰ The court, however, correctly refused to consider the bank's conduct in paying prior overdrafts as a course of dealing under section 1-205(1) because the conduct was all under the current agreement, rather than a prior one.²⁹¹ The court then noted that, while the bank's conduct might amount to a course of performance under section 2-208, that provision was applicable only within the scope of Article 2 and had absolutely no applicability under Article 4.²⁹²

It is worth noting that, in this case, the customer's argument was based on the use of a course of performance to interpret the deposit agreement.²⁹³ Would *Schaller* come out differently under revised section 1-303(a)? It certainly might go to a jury, particularly if a court employed the approach of the court in *Nanakuli*.²⁹⁴ Whether or not one agrees that the bank's customer should prevail, the newly broadened application of course of performance evidence will likely have a significant effect under Article 4.

The application of section 1-303(a) under Articles 5 and 9 will undoubtedly raise new issues as well. One that may be worth considering

286. *Id.* Even those instances in which the bank contacted the customer may amount to a course of performance under section 1-303(a), inasmuch as there is no evidence the bank formally reserved its rights in conformity with section 1-308(a). See discussion *supra* Part IV.B.

287. *Schaller v. Marine Nat'l Bank*, 388 N.W.2d at 647.

288. *Id.*

289. *Id.* at 648-49.

290. *Id.* at 649.

291. *Id.* at 650.

292. *Id.* (explaining the inapplicability of course of performance to Article 4 by stating that section 2-208 "relates specifically to ongoing sales contracts and is nowhere made applicable to banking relationships").

293. *Id.* at 649-50. While a few parties have previously made the argument outside Article 2, all have been rejected. See *supra* notes 257, 262, 264.

294. See discussion *supra* Part III.B.

involves the position of the parties that may be engaged in a dispute in which a course of performance may be applied. Under Article 5, a seller/beneficiary of a letter of credit may argue that a buyer/applicant or an issuing bank has engaged in a course of performance that is relevant under section 1-303(a) in determining what is required from the seller/beneficiary to invoke its right to payment by the issuing bank. Likewise, a buyer of property subject to a security agreement may argue that the secured party has engaged in a course of performance of allowing the sale of a particular debtor's secured collateral, thus indicating that the security agreement intended to allow for such sales.²⁹⁵

Each of these potential applications under Articles 5 and 9 is different from that of a typical Article 2 application in that the meaning of the agreement is being disputed by a nonparty. In the case of an Article 5 letter of credit, an intended beneficiary²⁹⁶ is arguing that it knows best the subjective intent of the parties, as shown by their subsequent actions. In the case of an Article 9 security agreement, a buyer of secured property is arguing that it knows best the subjective intent of the parties, as shown by their subsequent actions. The effects of each of these applications are unclear, but, again, the broadened application of course of performance evidence may have significant effects under Articles 5 or 9.²⁹⁷

A fifty-year-old dialogue is particularly enlightening when considering the use of course of performance evidence to interpret letters of credit under Article 5. Backus and Harfield raised concerns about a

295. See *supra* notes 243-44 (discussing Article 9 cases that might be affected if a course of performance were used for interpretation).

296. The intended beneficiary is the party to whom the bank issuing the letter of credit (at the request of the bank's customer) guarantees payment, provided that the terms of the letter of credit are met. See U.C.C. § 5-102(3) (1995) (defining "beneficiary").

297. Application of section 1-303(a) under Article 9 may also raise issues with respect to a third party of perfected security interests and whether or not the third party would be on notice of the meaning of a properly filed financing statement, where such meaning was informed by the parties' course of performance. For example, suppose a financing statement listed a debtor manufacturer's "finished goods inventory." Subsequent to the execution of the financing agreement between debtor and creditor, both parties treated both the finished goods and raw materials (i.e., finished goods from a seller for use as raw materials by our debtor manufacturer buyer) as secured by the financing agreement. Does such a course of performance change the meaning of the financing agreement? Does it affect the right of a third party who might acquire an interest in the manufacturer's raw materials? This is just one example of the myriad of challenges that may arise under Article 9 if course of performance evidence is used for interpretation.

recent decision approving a court's resort to trade usage in the interpretation of a letter of credit.²⁹⁸ The authors expressed fear that the use of such evidence in the interpretation of letter of credit agreements would frustrate freedom of contract and undermine the necessary certainty required for the operation of letters of credit as financial instruments.²⁹⁹ John Honnold responded in support of the *Dixon* decision, explaining that the use of trade usage and course of dealing evidence to interpret letters of credit was perfectly appropriate, because each was part of the objectively reasonable expectations of the parties at the time of contracting.³⁰⁰ Obviously, the same cannot be said of course of performance evidence, which does not yet exist at the time of contracting.³⁰¹

These, and perhaps a few other,³⁰² questions may present significantly

298. See Dana C. Backus & Henry Harfield, *Custom and Letters of Credit: The Dixon, Irmaos Case*, 52 COLUM. L. REV. 589, 598-600 (1952) (setting forth illustrations to demonstrate the danger "of permitting the *Dixon, Irmaos* rule [relating to application of trade usage and course of dealing evidence] to run beyond the confines of the facts in that particular case"); see also *Dixon, Irmaos & Cia, Ltda. v. Chase Nat'l Bank*, 144 F.2d 759, 762 (2d Cir. 1944) (incorporating by implication a custom of New York banks into the terms of a letter of credit).

299. Backus & Harfield, *supra* note 298, at 598, 602.

300. John Honnold, *Letters of Credit, Custom, Missing Documents and The Dixon Case: A Reply to Backus and Harfield*, 53 COLUM. L. REV. 504, 508-10 (1953). Honnold does not actually use the term "course of dealing," likely because the Code was in its infancy at the time. However, his argument in support of the use of the party's own "connotations which have been created by his past associations with that word" would seem to fairly encompass both trade usage and course of dealing evidence. *Id.* at 509.

301. See discussion *supra* Part III.A.

302. Even if the use of a course of performance is limited to waiver or modification, the language of section 1-303(f) raises some interesting additional questions. Any application of waiver or modification is "[s]ubject to Section 2-209." U.C.C. § 1-303(f) (2001). Thus, while resolving any question of the use of course of performance evidence throughout the Code, section 1-303 raises new questions with respect to the application of an Article 2 provision beyond the confines of Article 2.

Does this "subject to" language mean that section 2-209 in its entirety applies beyond Article 2? This is not likely, as it would be nonsensical to broadly apply section 2-209(3), which deals solely with Article 2's own statute of frauds. U.C.C. § 2-209(3) (2003). On the other hand, it seems clear that the language does intend section 2-209(5) to apply, providing for retraction of any waiver upon reasonable notice absent reasonable and detrimental reliance. *Id.* § 2-209(5). However, if the intent of section 1-303(f) is only to make its application "subject to" section 2-209(5), it would seem the drafters would have provided such a citation. In addition, section 1-303 speaks of waiver and modification, and section 2-209(5) only deals with waiver. U.C.C. § 1-303(f) (2001); U.C.C. § 2-209(5). This raises the more difficult question of the broad applicability of sections 2-209(1) and (2).

greater challenges in the application of newly revised Code section 1-303 than might otherwise be anticipated based on the cursory comments of its drafters.³⁰³ If the use of postformation course of performance evidence is reasonably limited to: (1) waiver, to the extent such conduct is at all ambiguous;³⁰⁴ or (2) modification, where appropriate intent is found, then the change may indeed pass with little effect. However, if we see course of performance evidence used for interpretation throughout the Code, in a fashion similar to that in *Nanakuli*, then the effects may be far-reaching indeed.

VII. CONCLUSION

In this Article, I have tried to invite courts and scholars to pause and rethink what has become a somewhat mechanical application of postformation course of performance evidence to determine prior contractual intent. I also invite legislators considering revised Article 1 to think carefully about the advisability of making course of performance evidence applicable throughout the entire Code, or at least to think about adding comment 3 from former section 2-208 to new section 1-303.³⁰⁵

Does section 2-209(1) now apply throughout the Code to dispense with any need for consideration in the case of a contract modification? While Article 5 dispenses entirely with the requirement of consideration, U.C.C. § 5-105 (1995), a broad application of section 2-209(1) would seem to have potentially significant effects under Articles 3, 4, 7, or 9. The language of section 2-209(1) seems to expressly limit its application to Article 2. *See* U.C.C. § 2-209(1) (stating that modification of a contract “within this Article needs no consideration to be binding”). However, this provision is one of only two in section 2-209 that could apply to modification beyond Article 2. The other is section 2-209(2), which makes “no oral modification” clauses enforceable under Article 2, U.C.C. § 2-209(2), a position inconsistent with the prevailing approach under common law. FARNSWORTH, *supra* note 138, § 7.6.

Lastly, section 2-209(4) would only seem to be applicable to the same extent as section 2-209(2). *See* U.C.C. § 2-209(4) (addressing circumstances that fail the requirements of subsections 2 or 3, the latter of which clearly does not apply outside Article 2). Thus, we are left with an open question as to whether section 2-209(1), or 2-209(2), or both might apply throughout the Code.

303. *See* discussion *supra* Part I.C. and note 50.

304. I would suggest that pure conduct is virtually always ambiguous by nature.

305. Admittedly, any variation from the uniform version of Article 1 would be contrary to the underlying goal of uniformity expressed in section 1-103(a)(3). *See* U.C.C. § 1-103(a)(3) (2001) (stating that an underlying purpose of the Code is “to make uniform the law among the various jurisdictions”). However, this seems justified under these circumstances. In any event, a modification relating only to comment 3 would seem less of a problem where retaining a former comment rather than adding an entirely new one.

Perhaps Karl Llewellyn knew exactly what he was doing when he left the Code's treatment of course of performance evidence narrowly cabined within Article 2. His notes certainly show us that a meaningful preference for waiver, as expressed in comment 3 to section 2-208, was important to him in view of the potential adverse commercial effects absent such a preference. I believe there are serious questions as to the advisability of adopting revised section 1-303(a), as written. However, if this section is adopted, a meaningful preference for waiver is absolutely necessary—now more than ever before.