No. S129463

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

CITY OF HOPE NATIONAL MEDICAL CENTER,

Plaintiff and Respondent,

v.

GENENTECH, INC.,

Defendant and Appellant.

After A Decision Of The Court of Appeal,
Second Appellate District, No. B161549

Appeal from Judgment Of The Superior Court
For The County Of Los Angeles (No. BC 215152)
(Hon. Edward Kakita (Ret.), Sitting By Assignment)

APPLICATION OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, CALIFORNIA CHAMBER OF COMMERCE, AND TECHNET FOR PERMISSION TO FILE BRIEF OF AMICI CURIAE AND BRIEF OF AMICI CURIAE SUPPORTING THE APPELLANT

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APPLICATION OF THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, CALIFORNIA CHAMBER OF COMMERCE, AND TECHNET FOR PERMISSION TO FILE BRIEF OF *AMICI CURIAE* SUPPORTING THE APPELLANT

The Chamber of Commerce of the United States, California Chamber of Commerce, and Technet respectfully apply for permission to file the attached brief of *amici curiae* in support of the appellant.

The **Chamber of Commerce of the United States of America** is the world's largest business federation. It represents an underlying membership of more than three million businesses, state and local chambers of commerce, and organizations of every size and in every sector and geographic region of the country. The Chamber has thousands of members in California, and thousands more conduct substantial business in the State. For that reason, the Chamber and its members have a significant interest in the administration of civil justice in the California courts. The Chamber routinely advocates the interests of the national business community in courts and before lawmakers across the Nation. See generally http://www.uschamber.com.

The **California Chamber of Commerce** is a nonprofit corporation, founded more than a century ago, that represents approximately 15,000 companies of all types and sizes. Its members employ one-fourth of the state's private-sector workforce. The California Chamber represents the interests of businesses before lawmakers and frequently participates as an amicus curiae in cases affecting business interests in the California courts. The California Chamber is a member of the Chamber of Commerce of the United States. See generally http://calchamber.com/about_us/about.htm.

TechNet is a bipartisan network of more than 150 chief executive officers and senior partners of companies in the fields of information technology, biotechnology, venture capital, investment banking, and law. TechNet strives to promote the growth of technology industries and of the economy by building long-term relationships between technology leaders and policymakers. See generally http://www.technet.org/who/index.html.

The proposed brief of *amici curiae* addresses the tort liability that was superimposed on the contractual dispute in this case. The $200 million punitive damages element of the judgment rests on the erroneous proposition that a fiduciary relationship arises whenever one party agrees to develop and commercialize another's intellectual property ("IP") and to pay royalties. The brief also addresses the lower courts' treatment of disputes over extrinsic facts as a basis to abdicate the judicial responsibility to interpret the contract at issue here—an interpretation on which tort liability as well as contract liability depends.

Each *amicus* has a significant interest in these issues, as each represents owners, licensors and licensees of IP. Because commercial agreements for the use of IP have become central to the high-technology economy, the *amici* share a strong interest in ensuring that the IP licensing system continues to contribute to commercial stability, innovation, and economic growth.

The proposed brief explains why the intrusion of tort principles and remedies into this contract dispute violates precedent and sound policy alike. The proposed brief examines the reasoning of decisions of this Court that have kept tort remedies out of contract disputes and explains why the same policies should apply to agreements to use IP. The proposed brief further explains why fiduciary duties cannot properly be invoked to inject punitive damages into a commercial contract dispute over royalties. In particular, the proposed brief demonstrates that agreements to develop and pay royalties for IP do not create fiduciary relationships under the governing principles enunciated by this Court. Throughout the proposed brief, the *amici* explain the deleterious consequences of expanding fiduciary duties and tort remedies to encompass commercial contracts to use IP.

Routinely imposing fiduciary duties on parties that purchase or license IP would severely impede the formation and operation of IP agreements—especially agreements to sponsor innovative research in exchange for the rights to license and develop the resulting IP. Categorical fiduciary duties arose to protect parties in particularly vulnerable positions from exploitation, and properly are confined to a few well-established legal relationships that involve vulnerability and trust that far exceed those present in a business agreement. A contract to develop and commercialize IP is not, and should not be, among the few business relations that produce tort duties as a matter of course. Businesses should not become trustees whenever they buy or license IP in exchange for royalties.

In addition, the judgment of contractual breach—the "tortious" conduct at issue here—rested on a jury's black-box determination of liability, based on its own unexpressed and unexplained interpretation of the parties' agreement. Yet, under interpretive principles set forth by this Court, the text of that agreement almost certainly could not have been interpreted to impose a royalty obligation on Genentech for third parties' non-infringing products. The jury was assigned the full interpretive task because some extrinsic evidence arguably could have affected a proper interpretation of the contract. Had the jury instead been confined to resolving factual disputes, and had the courts below instead carried out their proper role in interpreting written instruments, the result likely would have been different, and the adjudication certainly would have been explicit and principled. The proposed brief urges the Court to take a first step toward restoring the integrity of written contracts in the California courts, by confining the jury's role to the resolution of disputed facts rather than the complete interpretation of contracts.

All California businesses, even those that do not regularly engage in IP licensing, have a stake in seeing that California law maintains a clear distinction between contract and tort damages—a distinction significantly eroded by the judgment rendered below. Likewise, all businesses have a strong interest in making the interpretation of written contracts more stable and predictable. If this Court permits one class of commercial contracts to be characterized as fiduciary rather than arm's-length, other courts may be expected to produce rationales for including other types of contracts within the reach of tort duties and tort damages, undermining the efficient separation of tort and contract law that this Court has enforced for many years. This Court should limit the intrusion of fiduciary duties into arm's-length relationships, and of tort remedies into contract disputes. And it should return the task of interpreting contracts to courts rather than juries.

CONCLUSION

The application for permission to file brief of amici curiae should be granted and the brief filed.

Dated: January 27, 2006

Respectfully submitted.

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INTEREST OF THE *AMICI CURIAE*

The interest of the *amici* is fully described in the Application for Permission, *ante*. The **Chamber of Commerce of the United States of America** is the world's largest business federation. The **California Chamber of Commerce** represents approximately 15,000 companies that employ one-fourth of the state's private-sector workforce. **TechNet** is a bipartisan network of more than 150 chief executive officers and senior partners of companies in the fields of information technology, biotechnology, venture capital, investment banking, and law.

Each *amicus* has a significant interest in the question whether an agreement to develop (and pay royalties for) intellectual property ("IP") creates a fiduciary relationship, so that a breach of the agreement potentially may result in punitive damages. Each organization represents owners, licensors and licensees of IP. Because commercial agreements for the use of IP are of paramount importance to the high-technology economy, the *amici* share a strong interest in ensuring that the IP licensing system continues to contribute to commercial stability, innovation, and economic growth. The *amici* urge this Court to limit the intrusion of fiduciary duties into arm's-length relationships, and of tort remedies into contract disputes. Similarly, because it is important to businesses to be able to rely on principled interpretations of their written agreements, the *amici* urge the Court to take the opportunity presented here to return the task of interpreting contracts to the courts—where statute and common law alike have allocated it—rather than juries. Using extrinsic evidence to vary the substance of written agreements is, in our view, unwise; using extrinsic evidence to change the identity of the decisionmaker is completely unjustified, and this Court should put a stop to the practice.

INTRODUCTION

The intellectual property dispute in this case has no business masquerading as a tort, much less one worth hundreds of million dollars in punitive damages. This Court has repeatedly turned back efforts to transform contract disputes into torts (aside from a limited set of disputes involving insurers). Yet in this case a dispute over an agreement by one sophisticated party to pay royalties for another's intellectual property somehow produced tort liability and $200 million in punitive damages—on the startling premise that the royalty agreement rendered one business the *trustee* of the other, for that is what a "fiduciary" is.

The tort judgment contravenes principles that this Court has invoked repeatedly in rejecting tort remedies for breaches of noninsurance contracts. The Court has made clear that the "tortification" of contract law

- ignores important differences between the objectives of contract and tort law;
- overrides the finely balanced allocations of risks and rewards that private parties have negotiated in their contracts;
- deprives commercial dealings of stability and predictability; and
- spawns needless litigation.

Despite that clear message, in this case tort law intruded into contract under the label of fiduciary duties. That label compounds the distortion of the law. California law confines fiduciary *duties* to a narrow and familiar class of fiduciary *relationships* in which one party necessarily must place a heightened trust in another. By contrast, the reliance that every contracting party places on the other's performance—even a performance that may be difficult to monitor unless the agreement provides means to do so—does not make one contract party into the other's keeper, subject to fiduciary duties and to tort remedies that may include massive punitive damages.

The jury in this case was instructed that a novel *per se* fiduciary relationship arose whenever one party "entrusted" its "secret" IP to another in exchange for royalties. But this Court held years ago that no confidential relationship—much less a full fiduciary relationship—arises from the transmission of supposedly secret IP through "arms length negotiations." *Davies v. Krasna* (1975) 14 Cal.3d 502, 510-511.

Indeed, one can scarcely imagine a worse fit for fiduciary duties. Few areas of business require more transactional fluidity than the exchange of IP, a trade that permits innovations to find their most efficient and most socially beneficial uses. Few legal doctrines constrain the free flow of commerce more completely than fiduciary duties, which treat one fully competent commercial actor as the helpless ward of another, and substitute the rarefied, protective atmosphere of fiduciary relationships governed by tort law for the arm's-length, private ordering of affairs by contract.

In an economy increasingly driven by the development and sale of intellectual property, grave consequences attend the insertion of fiduciary duties (and thus the wild card of punitive damages) into the otherwise predictable contractual relationship between the original owners of intellectual property ("IP owners") and those who develop or use the property under a license, assignment, or similar arrangement ("IP users"). Intellectual property agreements ("IP agreements") encompass a wide variety of contractual arrangements in which an IP user obtains IP rights in return for a promise to pay royalties on an ongoing basis to the original IP owner.[1] For example, within the realm of patents, an agreement may involve an "assignment" or outright sale of a patent. An agreement instead may convey a "license" or right to exploit the patented invention. As an alternative, an IP owner may sell the right to own and patent a potential invention in exchange for research funding as well as future royalties, as occurred in this case. Although this case arose from patented technology, copyright licenses and assignments may raise similar issues.

IP agreements have been critical to the economic growth and development of California, the United States, and, indeed, the world. Intellectual property assets have become increasingly significant within the world economy, accounting for more than 20% of world trade.[2] Patent licensing revenues alone increased from $15 billion in 1990 to well over $120 billion in 1999, and are expected to reach over $500 billion by the middle of the

[1] In this case, City of Hope was the original "IP owner" because it conveyed to Genentech the rights to own, patent, and use certain IP developed by City of Hope scientists. Genentech was the "IP user" because Genentech obtained those IP rights from City of Hope, and proceeded to obtain patents and develop, market and license products practicing City of Hope's IP.

[2] Clarkson, *Avoiding Suboptimal Behavior in Intellectual Asset Transactions: Economic and Organizational Perspectives on the Sale of Knowledge* (2001) 14 Harv. J.L. & Tech. 711, 714-715.

next decade.[3] Royalties and license fees accounted for $52 billion of U.S. exports in 2004, up from $20 billion in 1992.[4]

The amici's members include IP owners as well as IP users, and have a strong economic interest in seeing that IP users fulfill their royalty obligations. That goal is fully met by contract damages and by privately negotiated contract provisions designed to ensure that IP users will properly pay and account for royalties. If this Court affirmed the fiduciary-duty aspect of the judgment, however, IP owners could raise the spectre of punitive damages in virtually every royalty dispute.

Imposing fiduciary status as a cost of using third-party IP would severely impede the productive flow of ideas from inventors to those who can most effectively bring those ideas to the public. A tort-based regime would particularly threaten the high-technology sector, where IP agreements are common, and where agreements to fund research and development are critical to innovation. As risk increased, prudent IP users would avoid entering into IP agreements that place them at such a decided disadvantage relative to IP owners. This reluctance would especially reduce investment in research and development for IP that is not yet patented—that is, the very newest technologies with the greatest potential social value.

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[3] Burton et al., *Strategic Role of Intellectual Property in Company Valuation and Financing, in* Handling Intellectual Property Issues in Business Transactions (2002) pp. 9, 20. In 2001, IBM alone earned $1.7 billion licensing its patents. See *More Rembrandts in the Attic: Britain's BT Hopes to Make Money From Dusting Off Its Patents* (Jan. 19, 2002) Economist, p. 53.

[4] See U.S. Census Bureau, U.S. International Trade In Goods and Services (2004 Final Revision) Exs 2, 19, at http://www.census.gov/foreign-trade/Press-Release/2004pr/final_revisions/index.html.

The significance of the tort component of this case extends beyond IP. If this Court were to characterize one set of common commercial contracts as fiduciary relationships, more courts might follow with their own discoveries of fiduciary duties in other contract settings. Once allowed outside its traditional boundaries, the fiduciary concept could produce an ever-expanding tort-based regime where businesses—on pain of punitive damages—are expected to be accommodating rather than efficient. That is bad law, bad economics, and bad social policy. This Court should adhere to the established principles distinguishing tort from contract, and arm's-length dealing from fiduciary solicitude, to reverse the tort verdict and vacate the punitive damages award.

The unfounded tortification of a contract dispute here underscores the significance of the other fundamental issue presented in this case. Where a contract breach may present such high stakes—and the contract damages alone in this case reached $300 million—the need for predictability in contract interpretation is especially strong. But predictability has been largely lacking in California since the 1960s, when a number of decisions by this Court effectively relegated the text of written contracts to little more than another piece of evidence about the parties' agreement. In an appropriate case, this Court should revisit those decisions and return the California courts to the mainstream of American jurisprudence. In California, as in other states, the terms of a written contract, as interpreted by courts applying settled legal principles, should define and govern the parties' enforceable obligations notwithstanding any negotiations or other extracontractual statements not reflected in the agreed-upon text.

In this case, however, extrinsic evidence was not only admitted to change the meaning of the written text, but the courts below used the admission of that evidence as a basis for changing the identity of the decisionmaker. Merely because there were factual disputes over certain aspects of the parol evidence, both lower courts turned the entire exercise of contract interpretation over to the jury. That should not happen. Even if a jury may be involved in the resolution of factual disputes that may affect contract interpretation—a questionable premise given the normal, historic allocation of contract interpretation to courts—the jury role should not go beyond the resolution of discrete factual disputes that have been framed in special interrogatories. Once any factual disputes have been resolved, the interpretation of the contract in light of its parol evidence remains a task for the court, one that can be reviewed *de novo* just like any other judicial interpretation of a written document. By ensuring that unelaborated jury verdicts do not displace the judicial function of contract interpretation, this Court can and should take a firm step toward enhancing the predictability of contract interpretation in this State.

ARGUMENT

The $200 million tort judgment depends on the validity of this jury instruction:

> A fiduciary relationship arises when a person entrusts a secret idea or device to another under an arrangement whereby the other party agrees to develop, patent and commercially exploit the idea in return for royalties. (RT 18406:6-11.)

That is, to affirm the judgment here, this Court would have to hold that any IP user that obtains rights to another's IP before the IP has been patented or otherwise made public becomes the IP owner's fiduciary. Moreover, this

Court would have to hold that an IP user risks punitive damages when it disputes the scope of its royalty payment and reporting obligations.

Holding that IP agreements create *per se* fiduciary relationships would expand the scope of a relationship that this Court has strictly limited. The purpose and effect of that expansion—to make tort remedies available for contractual breach—would serve a goal that the Court has consistently rejected. And the practical result of affirmance would be to inhibit commerce in intellectual property. The tort judgment is not sustainable, and should be reversed.

The contract judgment is no more sound. The courts in this case abdicated their role of interpreting the contract, instead treating the mere existence of parol evidence—evidence that, for all the parties' briefs indicate, was only peripherally relevant to the principal dispute—as a reason to allocate the task of contract interpretation to the jury. That practice greatly exacerbates the unpredictability caused by the lenient treatment of extrinsic evidence in the California courts. This Court should draw a firm line here, confining jury involvement to the resolution of factual disputes over the extrinsic evidence. The court can then apply the facts found by the jury within the context of a principled, judicial interpretation of the contract document. That process would limit the destabilizing effect of parol evidence on negotiated written agreements.

I. THIS COURT HAS CONSISTENTLY REJECTED SIMILAR EFFORTS TO SECURE TORT DAMAGES FOR BREACH OF CONTRACT.

The expansion of fiduciary duties in this case should be seen for what it is: a distortion of familiar legal doctrine to transform a contract breach into a tort. This Court has repeatedly refused to make tort remedies available for breach of noninsurance contracts—even for breaches committed intentionally and in bad faith. Rather, the Court has instructed, "[a] person may not ordinarily recover in tort for the breach of duties that merely restate contractual obligations." *Aas v. Superior Court* (2000) 24 Cal.4th 627, 643.

The Court has returned to this principle in refusing to recognize tort remedies for a wide variety of contractual breaches that lack grounding in a legal duty separate and independent from the contract itself. Thus, the Court extinguished two short-lived sham torts: (1) intentionally interfering with one's own contract and (2) denying the existence of a contract to which one allegedly is a party (a transparent way of recharacterizing a contractual breach). See *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 Cal.4th 503 (limiting intentional interference); *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 Cal.4th 85 (abrogating the so-called *Seaman's* bad-faith-denial tort). Unless a disappointed contractor can plead and prove a tort distinct from mere nonperformance of an agreement, only contract remedies are available.

This Court has rejected efforts to extend tort remedies to categories of contractual breaches that involve supposedly sensitive subject matter like the "secret idea or device" at issue here. Thus, wrongful termination of an employee raises only a contract claim unless the termination independently violates a fundamental public policy. See *Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654; *Hunter v. Up-Right, Inc.* (1993) 6 Cal.4th 1174, 1180-1182. And defective performance of a construction contract is no tort unless the breach physically injures a person or damages property apart from the building itself. See *Aas*, 24 Cal.4th 627; see also *Erlich v. Menezes*

(1999) 21 Cal.4th 543 (causing emotional distress does not make breach of construction contract tortious).

Insurance contracts remain the sole exception to this rule. Because the insurance exception represents "a major departure from traditional principles of contract law," this Court has refused to extend that exception to any other contractual setting and repeatedly has "cautioned courts to exercise great care" in considering whether to do so. *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28, 46 (internal quotation marks omitted); accord *Freeman & Mills*, 11 Cal.4th at 94; *Foley*, 47 Cal.3d at 690. Indeed, this Court did not extend the "insurance exception" even to construction performance bonds, which the Insurance Code recognizes as a type of "insurance." *Cates*, 21 Cal.4th at 46.

In deciding these cases, the Court has relied on several "compelling *policy* reasons supporting the preclusion of tort remedies for contractual breaches outside the insurance context." *Freeman & Mills*, 11 Cal.4th at 97 (emphasis in original). The same considerations should preclude misuse of fiduciary principles to provide tort remedies for breaches of IP agreements.

(1) Contract and tort law promote different objectives and afford different remedies. Reaffirming that "[c]ontract and tort are different branches of law," *Applied Equipment*, 7 Cal.4th at 514, the Court has enforced a structural separation between the two areas based on their differing policy objectives: "Contract law exists to enforce legally binding agreements between parties; tort law is designed to vindicate social policy." *Ibid.*; see also *Foley*, 47 Cal.3d at 506. As a consequence,

> [w]hereas an intentional tort is seen as reprehensible—the deliberate or reckless harming of another—the intentional breach of contract has come to be viewed as a morally neutral act, as exemplified in Justice Holmes's remark that "[t]he

> duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."

Freeman & Mills, 11 Cal.4th at 106 (Mosk, J., concurring and dissenting) (quoting Holmes, *The Path of the Law* (1897) 10 Harv. L. Rev. 457, 462.

In rejecting the so-called *Seaman's* tort for bad-faith denial of a contract's existence, this Court observed that almost any resistance by a breaching party could be characterized as tortious if firm adherence to a bargaining position, or "stonewalling," is enough to trigger tort remedies: "Such conduct by the breaching party, essentially telling the promisee, 'See you in court,' could incidentally accompany *every* breach of contract." *Freeman & Mills*, 11 Cal.4th at 103 (emphasis in original). The Court's answer: *no* stonewalling by noninsurers is tortious. *Ibid.*

Because motive is irrelevant to contract law, contract damages provide compensation—not punishment. *Foley*, 47 Cal.3d at 683. By contrast, "punitive or exemplary damages, which are designed to punish and deter statutorily defined types of wrongful conduct, are available only in actions 'for breach of an obligation *not* arising from contract.'" *Applied Equipment*, 7 Cal.4th at 516 (quoting Civil Code § 3294(a) (emphasis added)). Punitive damages are not available even for a fraudulent or malicious breach of contract. *Ibid.*

This Court would substitute tort principles for contract if it held that fiduciary relationships arose from the obligations assumed in a broad category of IP agreements. Because the supposed "fiduciary" duties would be co-extensive with the contractual obligations, allowing punitive damages for their breach would squarely conflict with the Court's recent but established jurisprudence.

*(2) **Private ordering through contract promotes stability and predictability in commercial relations.*** This Court has stressed "the need for stability and predictability in commercial affairs." *Freeman & Mills*, 11 Cal.4th at 102; see also, *e.g.*, *Foley*, 47 Cal.3d at 683. Tort remedies undermine contractual stability because they render contracting parties "subject to volatile and unpredictable juries that frequently act without regard to legal instructions." *Foley*, 47 Cal.3d at 695 (citation and quotation marks omitted) (discussing jurors' partiality to wrongful-termination claims). Injecting punitive damages into IP agreements would make an important category of commercial relations far less stable and predictable.

*(3) **Privately negotiated contracts provide a means for organizing business relations that is superior to*** **post hoc** ***reliance on a web of tort duties imposed by operation of law.*** Restricting tort damages in contract cases "encourag[es] contractual relations and commercial activity by enabling parties to estimate in advance the financial risks of their enterprise" and to allocate those risks contractually. *Erlich*, 21 Cal.4th at 550 (quoting *Applied Equipment*, 7 Cal.4th at 515). The parties to a contract "agree upon the rules and regulations which will govern their relationship" and that "define their respective obligations, rewards and risks." *Applied Equipment*, 7 Cal.4th at 517 (quoting brief of respondent in that case). Contract law enforces the obligations that each party has voluntarily assumed, and provides only the benefits each legitimately expected to receive under the agreement. *Id.* These "restrictions on contract remedies * * * protect the parties' freedom to bargain over special risks" and "promote contract formation by limiting liability to the value of the promise." *Freeman & Mills*, 11 Cal.4th at 98 (quotation marks and citation omitted).

By contrast, imposing a tort remedy may upset the carefully negotiated balance of power within a contractual relationship. For that reason, the Supreme Court refused to impose tort remedies that would cause "a significant shift in the balance of power between" a whole range of contracting parties; if the availability of expanded remedies would actually encourage the formation of agreements, parties would negotiate for those remedies. *Cates Construction*, 21 Cal.4th at 61; see *id.* at 57. Transforming a given set of contract duties into the basis for a tort, however, may make the risk of breach unacceptable. Allowing one side of a contract to "wield the club of tort and punitive damages" could coerce the other to "pay[] questionable * * * claims, or pay[] more on properly disputed claims," rather than "risk the outcome of a tort action." *Id.* at 58.

While "fear" of "giv[ing] rise to potential tort recovery" could deter efficient business conduct, see *Foley*, 47 Cal.3d at 696; see also *Freeman & Mills*, 11 Cal.4th at 109 (Mosk, J., concurring and dissenting), cabining tort remedies promotes efficient results. That is a particularly important policy goal in the context of IP development.

(4) Limited contract remedies encourage parties to avoid needless litigation. This Court repeatedly has voiced concerns that allowing tort recovery in contract cases "may open the door to increased * * * litigation." *Cates*, 21 Cal.4th at 59; see also, *e.g.*, *Freeman & Mills*, 11 Cal.4th at 102 (noting "overcrowded court dockets"). This could occur for at least two reasons. *First*, the allure of punitive damages may encourage a contractual party to take unreasonable positions that result in litigation, since actual or threatened tort litigation may produce a much greater payday than successfully negotiated contractual compliance. See *Cates*, 21 Cal.4th at 58. *Sec-*

ond, once litigation ensues, attaching tort remedies to contract claims inevitably results in "an expensive and time-consuming expansion of [contract] litigation into an inquiry as to the motives and state of mind of the breaching party. * * * The insult to commercial predictability and certainty" is exceeded only by "the increased burden on the already overworked judicial system." *Freeman & Mills*, 11 Cal.4th at 97 (quotation marks and citation omitted). If affirmed, the huge and well-publicized tort verdict in this case would only exacerbate these adverse effects.

(5) Extending tort remedies further into the commercial environment could injure the State's economy. This Court has recognized the potential harm to California's economy that would result from the profligate extension of tort remedies to contract breaches. Thus, in *Cates Construction*, the Court predicted that extending tort remedies to surety contracts would contribute to "the unaffordability of bonds." 21 Cal.4th at 59. In *Erlich*, the Court noted that "adding an emotional distress component to recovery for construction defects could increase the already prohibitively high cost of housing in California, affect the availability of insurance for builders, and greatly diminish the supply of affordable housing." 21 Cal.4th at 560. And in *Foley*, the Court warned that "[t]he expansion of tort remedies in the employment context has potentially enormous consequences for the stability of the business community" (47 Cal.3d at 699) because it could "alter profoundly the nature of employment, the cost of products and services, and the availability of jobs" (*Id.* at 694).

In Justice Mosk's forthright phrase, applying tort remedies to contracts threatens to "discourage commerce." *Freeman & Mills*, 11 Cal.4th at 109 (Mosk, J. concurring and dissenting). Similarly, using fiduciary duties as a path to tort remedies in the IP context would increase the costs associated with IP agreements, discouraging trade and investment in IP and thus impeding the development of IP itself.

(6) It is practically impossible to define a workable standard distinguishing "tortious" contractual breaches from others. Courts have found it nearly impossible to draw anything resembling a "bright line" between ordinary contract breaches and those meriting tort recoveries. Rather, as the *Seaman's* experiment demonstrated, "confusion and conflict" become the order of the day when contract bleeds over into tort. *Freeman & Mills*, 11 Cal.4th at 96; see also *Erlich*, 21 Cal.4th at 560 (tort rule "cannot provide any principled limit on liability"). Without a clear and principled standard, there is a "potential for converting every contract breach into a tort, with accompanying punitive damage recovery." *Id.* at 553. It becomes "difficult if not impossible to formulate a rule that would assure that only 'deserving' cases give rise to tort relief." *Foley*, 47 Cal.3d at 697.

The jury instruction in this case provided no limiting principle. City of Hope now suggests a four-part test that offers no improvement on that score. City of Hope's test would encompass virtually any agreement by one company to develop and market a new product conceived by another company, based on the inventor's "entrustment" of IP to a more able marketer whose control over its own business information supposedly renders the inventor's established institution—and, presumably, the institution's able corporate lawyers—"vulnerable." See AB 64-72. Because any breach of contract necessarily breaches the fiduciary's duty to subordinate its interests to those of the beneficiary, any contractual breach would be tortious.

II. CATEGORIZING IP AGREEMENTS AS "FIDUCIARY" DISTORTS THE LAW OF FIDUCIARY RELATIONS AND VIOLATES THE PUBLIC POLICIES PRECLUDING TORT REMEDIES FOR BREACHES OF CONTRACT.

Calling IP users the "fiduciaries" of IP owners uses the breach-of-fiduciary-duty label as a fig leaf for a revived effort to make some contractual breaches into "bad faith" torts. See Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. Ill. L. Rev. 897, 928. Under either label, juries may dispense punitive damages for breaches of contract on an *ad hoc* basis.

This Court has tightly cabined the types of relationships overlain with fiduciary duties. In particular, the Court has largely excluded fiduciary duties from the contractual setting, preferring to treat businesses (and individuals) as responsible adults capable of ordering their affairs by agreement without the intrusion of paternalistic legal rules. The Court's preference for private ordering in contract cases sharply conflicts with the expansion of fiduciary duties below.

A. IP Agreements Provide No Basis For Transplanting The Law Of Fiduciaries Into A Purely Commercial Sphere.

The jury was instructed that fiduciary duties *categorically* arise whenever an inventor "entrusts"—in exchange for royalty payments—a "secret" idea or invention to another who "agrees to develop, patent and commercially exploit the idea." RT 18406.[5] Under that definition, at a minimum, any enterprise that contracts for the rights to unpublished and undeveloped intellectual property rights becomes the inventor's trustee.

[5] We assume that the tort judgment rests solely on the quoted instruction defining a category of fiduciary relationships, as neither party's briefs identify another basis in the jury instructions for imposing fiduciary duties.

Indeed, given the ambiguity of the "entrustment" and "secrecy" elements, any enterprise that simply agrees to pay royalties risks fiduciary status.

City of Hope's newly minted standards for fiduciary relationships appear designed to afford fiduciary status to any IP license that has a product development component. See RB 64-73. Any license or assignment "entrusts" IP to the IP user; business deals routinely involve "entrustment" of the type that City of Hope claims is a foundation of a fiduciary relationship. See RB 67-68. IP licensees generally have "broad discretion" to exploit the license as they please, and may be expected to use the IP in light of their "specialized knowledge or expertise" in the type of business or industry that would use the IP. RB69. By definition, any licensee or assignee has far better "access to information" about its business than does the licensor. RB70. And, as a consequence, any IP owner is "dependent" on its licensee or assignee for royalty payments, and "vulnerable" to any deprivation of those payments or failure to account for them properly. RB71.

Such a broad extension of fiduciary duties into the relation between IP owners and IP users contradicts established principles governing the fiduciary relationship. IP users are not IP owners' trustees.

1. *The Relationship Between IP Users And IP Owners Has None Of The Traditional Characteristics Of A Fiduciary Relationship.*

Fiduciary duties arise where some fundamental aspect of a relationship between two parties leaves one party inevitably dependent on the other and unable adequately to protect itself through contract, so that the fiduciary has a duty to place the beneficiary's interest before its own. Thus, tort liability for a breach of fiduciary duty rests on the pre-existing status or relation of the parties, a "protective context" that justifies the imposition of tort duties. *Davies*, 14 Cal.3d at 510. As this Court has recognized, "arm's length negotiations between businessmen" do *not* provide any such "protective context"; rather, businesses are expected to look out for themselves. *Ibid.* Moreover, blackletter principles make clear that fiduciary duties cannot arise from the terms or subject matter of "an agreement or contractual relation between the fiduciary and the beneficiary." Restatement (Second) Torts (1979) § 874, Com. b (quoted in *Richelle L. v. Roman Catholic Archbishop* (2003) 106 Cal.App.4th 257, 273)). To the contrary, "[a]s a general rule, courts finding no fiduciary duty have done so 'where other legal relationships clearly existed between the parties which "covered" the transaction in suit and which were inconsistent with the existence of fiduciary duty.' (Chodos, The Law of Fiduciary Duties, *supra,* p. 61." *Oakland Raiders v. National Football League* (2005) 131 Cal.App.4th 621, 634. The routine contractual relationship between an IP owner and IP user amply "covers" their transactions and precludes the superimposition of fiduciary duties on those dealings.

Thus, although the existence of a contract does not confer *immunity* from tort liability on the contract parties, neither can a straightforward commercial contract *create* the kind of special relationship that would render tortious the mere pursuit of self-interest through adherence to a reasonable interpretation of the terms of the parties' agreement. To the contrary, if any fiduciary relationship could arise in the circumstances of this case, it would have to arise not from the terms of the agreement but from some structural and insuperable dependency on the part of a well-established hospital and research center (as City of Hope was and is) as it dealt with a start-up company (as Genentech then was).

Yet while "[t]he essence of a fiduciary or confidential relationship is that the parties do not deal on equal terms," *Beery v. State Bar* (1987) 43 Cal.3d 802, 813 (internal quotation marks omitted), there is no inherent imbalance between IP users and IP owners. The exclusive rights of IP *owners*, the beneficiaries of the fiduciary relation imposed below, counterbalance any economic power held by particular IP users. No one can lawfully use protectable IP (like the ultimately patented formulations here) without the IP owner's consent.

And mere imbalance alone does not suggest fiduciary duties in any event: even consumers subject to adhesion contracts are not the fiduciary wards of their vendors or lenders. See *Committee on Children's Television, Inc. v. General Foods Corp.* (1983) 35 Cal.3d 197, 221-222; *Nymark v. Heart Fed. Sav. & Loan Ass'n* (1991) 231 Cal.App.3d 1089, 1093; *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678, 692-694. A consumer may be able to evade some of her obligations if the contract is also unconscionable (*e.g.*, *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, 184-185), but she cannot turn a breach of contract into a tort simply by pointing to a disparity in bargaining power. Outside the traditional fiduciary relationships, only extreme and insuperable vulnerability or incapacity can prompt fiduciary duties. See *Persson v. Smart Inventions, Inc.* (2005) 125 Cal.App.4th 1141, 1161-1162. A situation like this one, where both parties had counsel and dealt on roughly equal terms, "is the antithesis of situations in which confidential relations give rise to fiduciary obligations." *Id.* at

1162. Indeed, even "confidential" misstates the nature of the arm's-length bargaining relationship between City of Hope and Genentech.

Fiduciary duties make no sense in the context of commercial IP development agreements for another reason. Fiduciary relationships are distinguished by one party's voluntary subordination of its own interests to another's. *Committee*, 35 Cal.3d at 222.[6] A fiduciary not only "*undertakes* to act *in the interest of another*," Scott, *The Fiduciary Principle* (1949) 37 Cal. L. Rev. 539, 540 (emphasis added); see *Committee*, 35 Cal.3d at 221, but also agrees to "giv[e] priority" to the beneficiary's interests. *Id.* at 222. Indeed, in most instances, "a fiduciary * * * forgoes the opportunity to act in his own interest at all."[7]

This element of voluntary unselfishness makes no sense at all in arm's-length dealings between business people. Commerce in general, and the development and commercialization of technology in particular, are profit-seeking activities, not altruistic ones. As a consequence, the classic fiduciary relationships do not fit the commercial context except where specialized, inherently altruistic services are supplied. Thus, a trustee's or an attorney's services by definition involve a heightened level of trust and a

[6] See also, *e.g.*, Black's Law Dictionary (6th ed.1990) p. 625; *Jones v. Ellis* (Ala. 1989) 551 So.2d 396, 402-403; *Destefano v. Grabrian* (Colo.1988) 763 P.2d 275, 284; *Andersen v. Albert & J.M. Anderson Mfg. Co.* (Mass. 1950) 90 N.E.2d 541, 543; *Wallad v. Access BIDCO, Inc.* (Mich. App. 1999) 600 N.W.2d 664; *Rosencrans v. Fry* (N.J. 1953) 95 A.2d 905; *Continental Potash, Inc. v. Freeport-McMoran, Inc.* (N.M. 1993) 858 P.2d 66, 77; *Belvedere Condominium Unit Owners' Ass'n v. R.E. Roark Cos., Inc.* (Ohio 1993) 617 N.E.2d 1075, 1082; *Pickens v. Hope* (Tex. App.–San Antonio 1988, writ denied) 764 S.W.2d 256, 267 (citing *Slay v. Burnett Trust* (Tex. 1945) 187 S.W.2d 377, 387-388); *Elmore v. State Farm Mut. Auto. Ins. Co.* (W.Va. 1998) 504 S.E.2d 893, 898.

[7] Burton & Andersen, Contractual Good Faith: Formation, Performance, Breach, Enforcement (1995) § 9.2.2. n.20. See Restatement (Second) Trusts (1959) §§ 2, 170; see also Restatement (Third) Trusts (2003) § 2.

subjugation of interest to the client or beneficiary. By contrast, the obligations of an IP user who pays to use IP come at arm's length. In that context, self-interest cannot be tortious, as it would be in a fiduciary setting.

Indeed, a "course of arms-length dealing" flatly precludes any "duty of loyal representation of the opposing party." *Gonsalves v. Hodgson* (1951) 38 Cal.2d 91, 99 (internal quotation omitted). See also *Davies*, 14 Cal.3d at 510. Buyers and sellers are "held to the mores of the marketplace," *Committee*, 35 Cal.3d at 222, unless they agree to subordinate their interests to act on their counterparts' behalf. *Nymark*, 231 Cal.App.3d at 1093 n.1.

To fashion, nonetheless, a new categorical fiduciary duty to cover IP licensing and product development agreements *despite the absence of* a joint venture, agency or partnership relation would conflict with deeply rooted California jurisprudence. From the earliest days, California courts have confined fiduciary duties to a strictly limited set of "peculiar relation[s]." *Robins v. Hope* (1881) 57 Cal. 493, 497 (citing 1 Story's Equity Jurisprudence 218), overruled in part on other grounds, *Seeger v. Odell* (1941) 18 Cal.2d 409, 416; see also *Bacon v. Soule* (1912) 19 Cal.App. 428, 433-435 (brother is not sister's fiduciary). See Genentech OB 21 (outlining those relationships).

This Court has closely policed the boundaries of those fiduciary relationships. For example, the Court made clear that, notwithstanding the added tort and contract duties owed by an insurer to its insured, an insurer is *not* a true fiduciary. *Vu v. Prudential Prop. & Cas. Ins. Co.* (2001) 26 Cal.4th 1142, 1150-1151. The Court likewise refused to interfere with an agreement between competent adults by extending the boundaries of the established fiduciary relationship between spouses to encompass persons who were merely engaged to be married. *In re Marriage of Bonds* (2000) 24 Cal.4th 1, 27-30.

Three broader types of business relationship—partnership, joint venture, and agency—*do* prompt fiduciary duties because one or more parties *do* undertake to act for others or for a common business entity. But the parties here agreed that their relationship here did *not* involve any of those relationships—*i.e.*, that neither undertook to act for the other. See 39 AA 10580 (Article 11.01). In light of this Court's solicitude for the integrity of private ordering of obligations through contract, the Court should give effect to an unambiguous contractual disclaimer of "relationship[s] that would connote [fiduciary] duties." *City Solutions, Inc. v. Clear Channel Communications, Inc.* (N.D. Cal. 2002) 201 F.Supp.2d 1048, 1050, appeal dismissed (9th Cir. 2004) 365 F.3d 835. "[V]oluntary contractual arrangements" of this kind should prevail over any judicial sense of "proper business decorum." *Freeman & Mills*, 11 Cal.4th at 99 (quoting *Oki America, Inc. v. Microtech Int'l, Inc.* (9th Cir. 1989) 872 F.2d 312, 316 (Kozinski, J., concurring)).[8]

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[8] One panel of the Court of Appeal, confronting a contractual provision labeling one party as an independent contractor, has asserted that a joint venture may exist "despite an express declaration to the contrary." *April Enterprises, Inc. v. KTTV* (1983) 147 Cal.App.3d 805, 820. But *April Enterprises* concerned only a "label[]ing of [one party] as an independent contractor," not an explicit *disclaimer* of any *joint venture*. Neither did *Universal Sales Corp. v. California Press Mfg. Co.* (1942) 20 Cal.2d 751, 765, the sole support cited in *April Enterprises*, involve such a disclaimer. And neither did *O.K. Boiler & Welding Co. v. Minnetonka Lumber Co.* (Okla. 1924) 229 P. 1045, 1047-48, on which *Universal Sales* relied, nor *Fewell v. American Surety Co.* (Miss. 1900) 28 So. 755, on which *O.K. Boiler* relied. Indeed, the three earlier cases involved no express characterizations or disclaimers in the relevant contracts at all.

An IP licensee's control over IP results from the licensee's *paying* to use the property in its *own* interest, by contrast with a trustee or other agent (like an attorney or stockbroker) who generally *is paid* to take control of the property of the beneficiary or principal. "Control" over another's property that results from an agreement to *pay* for that privilege does not give rise to fiduciary duties in the context of IP agreements any more than a rental agreement makes the renter the broad fiduciary of the landlord or chattel owner.

An IP owner's royalties result from the IP user's pursuit of self-interest, not from its subordination of self-interest. If IP users owed IP owners the fiduciary duty of undivided loyalty, there would be no more IP agreements; only the purest altruist would enter into an agreement in which it was doomed to lose every dispute.

2. *This Court's Passing Reference To* **Stevens** *Precludes The Broad Significance That City Of Hope Assigns To The Case.*

The jury instruction imposing a categorical fiduciary duty on IP users paraphrased one of several formulations offered to justify the result in a straightforward fraud case, *Stevens v. Marco* (1956) 147 Cal.App.2d 357. This Court has cited *Stevens* only once—in *Davies v. Krasna*—and its treatment of the case is telling. In the discussion containing the citation to *Stevens*, this Court made clear that the mere transmission of a "secret" does not *create* a "fiduciary-like" confidential relationship (much less a truly fiduciary relation), but only triggers additional duties imposed by any "protective context" that arose from the parties' *prior* dealings or relationship. *Davies*, 14 Cal.3d at 510-511. The Court explicitly contrasted the attorney-client setting in *Stevens*, in which an inventor "transmit[ted] the idea *in the* *protective context* of a confidential relationship" that is based on something other than the transmission itself, with the setting of *Davies* (and this case), which involved the transmission of IP "in the course of arms length negotiations between businessmen who can profit from its exploitation." *Id.* at 510 (emphasis added).

In any event, despite the broader language of the opinion, *Stevens* presented two traditional bases for fiduciary duties, neither of which is present in IP agreements generally: attorney-client and joint venture relations. Although City of Hope downplays the attorney-client setting (AB 75-77), this Court pigeonholed *Stevens* as involving "an inventor" who "reveal[ed] his concept to a patent lawyer" (*Davies*, 14 Cal.3d at 510), and *contrasted* that situation with one in which a "secret" was transmitted through arm's-length negotiations (*id.* at 511). And the *Stevens* court itself found that the parties' relationship was equivalent to a joint venture (147 Cal.App.2d at 374-376), because both parties were involved in the research, development, promotion, and marketing of their joint product; the contract in *Stevens* did not disclaim the joint venture relation.

Thus, at the time of the IP assignment and formation of the venture, the defendant in *Stevens* was both the plaintiff's attorney and the plaintiff's joint venturer. If the authority of *Stevens* persists at all, it is only insofar as it applies those traditional fiduciary categories. As Genentech explains (OB 29-30), the broader statements in the case do not reflect the law of this State.

B. No Public Policy Supports Adding Fiduciary Duties Atop The Ample Contractual Means Available To Preserve IP Owners' Rights.

A new fiduciary duty (and new tort) tailored to IP agreements would not "vindicate" any significant "social policy," as this Court requires when considering expansion of the scope of tort law. *Applied Equipment*, 7 Cal.4th at 515. Using tort duties to reorder relations in IP agreements is unnecessary—indeed, counterproductive—because common contract provisions apparent in any licensing treatise or form book provide all the protection that any IP owner could need, and do so in a far more orderly and predictable manner. By contrast, we are aware of no reference recommending that parties insert language explicitly imposing fiduciary duties or punitive damage remedies into their IP agreements.

That is because a reasonably well-drafted IP agreement can provide contractual incentives to develop and commercialize a "secret" product. To sharpen these incentives, parties can agree to a flat, minimum royalty payable whether or not the IP user generates any revenue from the invention. Contract terms also can explicitly require the IP owner to use its "best efforts" to exploit the invention. Indeed, best efforts obligations are routinely implied into deals like this one, where one party supplies something to the other, which the other has the exclusive right to market, precisely because "otherwise the supplier would have delivered himself into the dealer's power." Richard Posner, *The Law and Economics of Contract Interpretation* (2005) 83 Tex. L. Rev. 1581, 1585. A contractual best-efforts obligation, not the tort duties of a fiduciary, provides the answer to the concerns that City of Hope raises here. Minimum-royalty provisions and best-efforts clauses are familiar to both the form books and the courts.[9] Tort duties are superfluous.

City of Hope contends that the contractual regime does not adequately protect businesses because of the difficulty of monitoring the other side's performance. AB 86. But contract parties have to monitor each other's performance all the time, especially where one party shares in the profits of another, by royalty or otherwise.

Thus, IP licenses routinely contain contractual provisions that encourage the timely and accurate payment of royalties. Parties may agree to "royalty audits" and to provisions on recordkeeping and retention, inspection and copying of the IP user's records, periodic reporting and certification of reports, and access to the IP user's audited financial statements.[10] Parties may reduce monitoring and compliance costs, and minimize disputes, by negotiating an explicit "total sales license" that makes it unnecessary to determine whether any given product infringes licensed patents or

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[9] *E.g.*, *Alling v. Universal Mfg. Corp.* (1992) 5 Cal.App.4th 1412 (best efforts clause); *Sass v. Hank* (1951) 108 Cal.App.2d 207 (minimum royalty); *Schrank v. Sterling Prods. Co.* (1939) 33 Cal.App.2d 107 (same); Barrett, *The Patent License: Standard Clauses and Variations*, in Practising Law Institute, Technology Licensing and Litigation: 1995 (1995) pp. 211, 228-29 (minimum royalties), 236-37 (best efforts or due diligence clauses). See *also* 1 Eckstrom's Licensing in Foreign and Domestic Operations (2003) §§ 3:30 (minimum royalty), 3:34 (best efforts).

[10] See Schmidt, *Royalty Audits*, in Litigation Services Handbook: The Role of the Financial Services Expert (Weil et al. eds., 3d ed. 2001) ch. 25 at pp. 1-5; Holmes, Patent Licensing: Strategy, Negotiation, Forms (2002) §§ 5:1-5:5, at 5-1 to 5-33. IP agreements routinely reflect the IP owner's "customary" right to inspect the IP user's records. Hickman, *The Patent and Technology License*, in Practising Law Institute, Understanding the Intellectual Property License (1997) pp. 251, 267.

otherwise uses the IP owner's property.[11] An IP owner would pay for this expansion of the royalty *base*, of course, by reducing the royalty *rate*.

Moreover, IP owners and IP users can allocate the costs of royalty monitoring so that a wronged IP user need not pay for the privilege of discovering it was underpaid. Parties may agree to submit all royalty disputes to binding arbitration, with the loser paying the winner's attorneys' fees. See Schlicher, *Some Thoughts on the Law and Economics of Licensing Biotechnology Patent and Related Property Rights in the United States* (1987) 69 J. Pat. & Trademark Off. Soc'y 263, 283. The parties also may agree that the IP user will pay for any royalty audit that results in its royalty payments being increased by a specified percentage. Holmes, Patent Licensing: Strategy, Negotiation, Forms (2002) § 5.4.2, at 5-4 to 5-5.

Indeed, even in the absence of these types of provisions, this Court long has recognized that a *contractual* right to an accounting is implicit in any contract calling for division of profits or payment of royalties, "for otherwise there would be no way * * * [to] determine whether there were any profits" on which royalties were due. *Nelson v. Abraham* (1947) 29 Cal.2d 745, 751 (quoting *Elliott v Murphy Timber Co.* (Or. 1926) 244 P. 91, 92). That right to an accounting does not rest on (and does not itself create) a broad fiduciary relationship that would prompt tort duties or tort damages. *Ibid.* Providing still further protection, the implied covenant of good faith and fair dealing precludes a party from sequestering "secret profit[s]" that an agreement calls to be divided, whether by royalty or other mechanism. *Ibid.* That, again, is a contractual obligation, subject to enforcement for

[11] See Schlicher, *Some Thoughts on the Law and Economics of Licensing Biotechnology Patent and Related Property Rights in the United States* (1987) 69 J. Pat. & Trademark Off. Soc'y 263, 283.

contract damages. But neither the express nor the implied contractual duties involve the one-sidedness inherent in a fiduciary relationship, where one party has a duty to put the other's interests ahead of its own.

To obtain royalty-protecting provisions beyond those implied in all royalty contracts, an IP owner must negotiate a smaller royalty or make some other concession to the prospective IP user. Imposing fiduciary duties on the contract's performance would rewrite that bargain, shifting the advantage in the IP owner's favor without giving the IP user anything in return. That unwise course would supplant the parties' carefully negotiated allocation of risks and rewards with open-ended tort remedies. Rather than giving IP users stronger incentives to account for and pay royalties in full, importing fiduciary duties into the business relationship between IP owners and IP users would discourage the formation of any relationship—and the payment of any royalties—at all.

C. Complex And Highly Technical Disputes Over IP Agreements Should Not Be Subject To Punitive Damages.

The primary practical significance of adding fiduciary duties to IP agreements is to permit IP users to extract punitive damages for a contractual breach. As this case demonstrates, in a fiduciary regime, an IP user could face punitive damages for adhering to an interpretation of an IP agreement that was sufficiently reasonable that the trial court submitted it to the jury. In effect, Genentech was punished for the very "stonewalling" that, this Court has held, cannot support even simple tort liability, much less punitive damages. *Freeman & Mills*, 11 Cal.4th at 103. A failure to deliver a promised performance is "morally neutral" even when intentional. *Id.* at 106 (Mosk, J., concurring and dissenting).

"Morally neutral" business activity of that kind (*Freeman & Mills*, 11 Cal.4th at 106), as a genus, is not "so reprehensible as to warrant the imposition of" punitive damages, a threshold requirement that must be satisfied in order for *any* punitive damage award to be consistent with due process. *State Farm Mutual Automobile Ins. Co. v. Campbell* (2003) 538 U.S. 408, 419. And California law precludes punitive damages even for malicious or fraudulent breaches of contract. *Applied Equipment*, 7 Cal.4th at 516. Settled state and federal legal principles weigh against rewriting the law of fiduciary duties so that juries routinely would be able to contemplate imposing punitive damages in disputes over IP agreements.

A dispute over the scope of an IP agreement provides a particularly inappropriate setting for punitive damages liability because of the numerous uncertainties that may dictate the ultimate result.[12] Genentech disputed the breadth of the royalty obligation, refusing to pay royalties on license fees from products that did not use IP from City of Hope. That position was more than justified. This Court has repeatedly enforced a common-sense presumption that, unless the parties clearly agreed to the payment of royalties on noninfringing products, royalties in patent licenses are payable only on products that would infringe the licensed patents. See *Farmland Irrigation Co. v. Dopplmaier* (1957) 48 Cal.2d 208, 224-25, 227 (Traynor, J.); *Eastman Oil Well Survey Corp. v. Lane-Wells Co.* (1943) 21 Cal.2d 872, 873-874. Disputing the scope of an agreement in reliance on that principle (or similar principles of contract construction)—if it can be tor-

[12] In an analogous context, punitive damages are not available for wrongful use of IP under a reasonable belief that the actions were authorized by a contract. *Zelinski v. Columbia 300, Inc.* (7th Cir. 2003) 335 F.3d 633, 641-642 (trademark and unfair competition case applying Illinois law).

tious at all—cannot be sufficiently fraudulent or reprehensible to support punitive damages. See Civil Code § 3294.

Similar uncertainties may arise in determining whether particular products trigger a royalty obligation. Many IP agreements cover technologically sophisticated inventions that form single aspects of complex products. For those agreements, reasonable disputes may arise over the computation even of royalties that are conceded to apply only to infringing products or processes. The question of infringement is so difficult to predict that patent litigation has proliferated in the federal courts—and about one-quarter of all infringement judgments of the district courts are reversed on appeal. Harmon, Patents and the Federal Circuit (6th ed. 2003), p. 1253.

Adding fiduciary duties, and thus punitive damages, to the mix despite these difficulties would have two immediate deleterious effects. First, fiduciary duties would shift "the balance of power between" the parties to IP agreements. *Cates*, 21 Cal.4th at 61. Each IP user would recognize that its refusal to capitulate to the IP owner's demands—even if based on a reasonable difference of opinion about the meaning of the IP agreement—could expose it to punitive damages. Thus, because of the punitive-damage risk, fiduciary duties would deter fully legitimate business conduct. See Rubin et al., BMW v. Gore*: Mitigating the Punitive Economics of Punitive Damages* (1997) 5 Sup. Ct. Econ. Rev. 179, 184-187 (describing overdeterrence caused by punitive damages); Dorff, *Attaching Tort Claims to Contract Actions: An Economic Analysis of Contort* (1997) 28 Seton Hall L. Rev. 390, 404 (noting similar social loss from increased risk aversion).

Second, imposing fiduciary duties would make the cost of operating under an IP agreement less predictable than the cost of infringing. Infringement damages are governed (and restrained) by federal law. Patent infringement damages are primarily compensatory. Although damages may be trebled for willful infringement, see 35 U.S.C. § 284, an enhancement "is inappropriate when the infringer mounted a good faith and substantial challenge to the validity of the patent or the existence of infringement." 7 Chisum on Patents (2001) §§ 20.01, at 20-7, 20.03[4][b], at 20-331 to 20-332 (footnotes omitted).[13]

By contrast, imposing fiduciary duties on IP users would allow mere nonpayment of royalties to result in punitive damages—even if nonpayment is based on a "good faith and substantial challenge" to the IP owner's contract interpretation. And state-law punitive damages, unlike willful-infringement damages, might exceed three times compensatory damages.[14]

Under these circumstances, a would-be IP user might well find infringement more attractive than licensing. "No potential user of a patented invention will accept a license if the cost of the license is greater than the discounted cost of losing an infringement action," Schlicher, *supra*, at 279, and the risk of massive punitive damages in a license dispute could tip the balance away from any deal. That is yet another reason why implying fiduciary duties into IP agreements makes no sense as a policy matter.

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[13] Copyright infringement damages also are confined to "actual damages and any additional profits of the infringer," 17 U.S.C. § 504(a), although the owner may choose statutory damages of up to $30,000 per work infringed, or $150,000 per work willfully infringed. *Id.* § 504(c).

[14] Although "few" punitive damages awards "exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process," the U.S. Supreme Court has declined to impose a bright-line upper limit on the ratio. *State Farm*, 538 U.S. at 425. This Court likewise has not imposed a limit. See *Simon v. San Paolo U.S. Holding Co.* (2005) 35 Cal.4th 1159, 1182.

In its own appeal to public policy, City of Hope seems to suggest that commercial contracts should engender fiduciary duties as a prophylactic against "corporate malfeasance" in light of "the avalanche of recent corporate scandals." AB 85. But City of Hope's random mudslinging at California businesses is entirely beside the point. The well-publicized "corporate scandals" did not involve royalty or other contract disputes, but for the most part involved real breaches of fiduciary duties by real fiduciaries—corporate officers and directors—to real beneficiaries: shareholders. No "corporate scandal" justifies turning commercial contractual relations into fiduciary ones.

III. THE TORTIFICATION OF THE CONTRACT DISPUTE IN THIS CASE UNDERSCORES THE NEED TO ENHANCE CONTRACTUAL PREDICTABILITY BY RETURNING THE TASK OF CONTRACT INTERPRETATION TO THE COURTS.

Setting aside the imprudence of extending fiduciary duties to commercial IP licenses and product development agreements, the supposed "tort" in this case rested on Genentech's purported breach of the license agreement. That a tort judgment, and $200 million in damages, rested on a contractual breach underscores the need for greater certainty in commercial contracting.

The jury's finding of a contractual breach depended on an implicit contract interpretation that assumed that Genentech would agree to pay much higher royalties on sublicenses—where third parties had all the profit opportunity—than on the products that Genentech developed and marketed itself. That is, the contract judgment can stand only if a 2% royalty on *all* of a third-party's products, whether or not they use City of Hope's patents is the "same royalty" (in the contract's words) that Genentech pays, which in the relevant period was triggered only by sales of products covered by the patents. (For present purposes, we overlook the case-specific limitation to products using DNA developed by City of Hope.)

Not only is there nothing in the text of the contract that suggests that the parties agreed to such an unlikely deal, but (as noted above) this Court has long presumed that, without a clear contrary agreement, agreements in patent licenses to pay royalties do not extend to products that do not infringe the licensed patents. See *Farmland*, 48 Cal.2d at 224-25, 227; *Eastman*, 21 Cal.2d at 873-874. And there is nothing in the contract to indicate that there was a total-sales royalty that applied only to the third-party sublicenses when a much narrower royalty base (at the same rate) applied to Genentech's own products. A court applying commonsense principles of contract interpretation to the written document reflecting the parties' agreement would have had no choice but to find the obligation here no broader than the norm established in *Farmland* and *Eastman*. See Posner, *supra*, at 1604-1605 (contract interpretations that do "not make commercial sense" should be rejected).

But the courts did not interpret the contract here. Rather, the jury did, based not only on the document itself but on all manner of testimony about negotiations that did not produce terms memorialized in the agreement—indeed, testimony about what was *not* discussed—and about the parties' separate intent or lack of it with respect to the scope of Genentech's royalty obligation for third-party licenses.[15] Indeed, if the briefing of both

[15] Indeed, the parol evidence in this case for the most part appears to have been the weakest kind of all: "a party's self-serving testimony that cannot be verified because it concerns his state of mind or a conversation to which the only witness was the other party to the contract, and that party either

parties is any guide, the trial record was almost entirely bereft of evidence about the provisions for royalties on third-party sales, much less evidence of clarity and pertinence sufficient to expand the scope of the interpretive task beyond the contract's text. Receiving no guidance on what limited factual disputes it might resolve, the jury was asked to interpret the contract only in the course of reaching a determination whether Genentech had breached the agreement. The jury did not need to say what it found that the contract meant, much less why.

That the jury apparently arrived at an anomalous contract interpretation should not be entirely surprising. Juries are not well-equipped to interpret written contracts. As Judge Posner has observed, "[j]urors rarely have commercial experience, and are generally, and I think correctly, considered unreliable judges of contract issues." Posner, *supra*, at 1594. The problem is that, when their role expands beyond determining disputed extrinsic facts—in the rare event those facts contribute to the interpretation of a disputed contract term—juries are all too likely to "disregard[] the actual, ascertainable meaning of a contract, as they might be inclined to do either because they were sympathetic to one side of the dispute or because they were credulous about testimony by one of the contracting parties that they meant something different from what the contract states." *Id.* at 1597.

That is why, when the four corners of a contract yield a clear and ascertainable meaning, only interpretation of the document in context, not the injection of extra-contractual evidence, should be needed to resolve a dispute. See Posner, *supra*, at 1597 (describing "four corners rule" of contract

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denies that the conversation takes place and or disagrees about what was said." Posner, *supra*, at 1598-1599. That type of evidence should never *create* an ambiguity, even if it could be admitted to resolve one.

interpretation). And that is why the framers of the Code of Civil Procedure made clear that judges, not juries, draw the task of interpreting contracts and other written documents whether or not extrinsic evidence is needed.

The Code sets out the principles of interpretation of an "instrument" (including an agreement) by defining "the office of the *Judge*," not the jury. Code Civ. Proc. § 1858 (emphasis added). It is the *judge* who must "ascertain and declare what is in terms or in substance contained therein, not * * * insert what has been omitted, or * * * omit what has been inserted." *Ibid.*

Indeed, the Code even addresses who should consider extrinsic evidence in arriving at "the proper construction of an instrument." Code Civ. Proc. § 1860. "[T]he circumstances under which it was made, including the situation of the subject of the instrument, and of the parties to it," may be admissible, not so that a jury can pick a winner, but "so that the *Judge* [is] placed in the position of those whose language *he* is to interpret." *Ibid.* (emphasis added).

But that is not what happened in this case, nor in many others in the California courts. This Court's 1960s contract jurisprudence set the stage for the decline of the contract as discernible written agreement, turning the contract into a mere launching pad for additional evidence. And with the ascendance of extra-contractual evidence in contract interpretation, more courts have turned over to juries not only the resolution of relevant factual disputes about extrinsic evidence, but the full task of interpreting the underlying written contract in light of those factual determinations.

The submersion of the written words of an agreement in a freewheeling presentation of evidence of the parties' other dealings and sentiments derives from *Pacific Gas & Electric Co. v. G.W. Thomas Drayage Co.*

(1968) 69 Cal.2d 33 ("*PG&E*"), a decision that Justice Mosk repeatedly and accurately characterized as an "aberration" (*Garcia v. Truck Ins. Exchange* (1984) 36 Cal.3d 426, 440 (Mosk, J., dissenting)). See also *Delta Dynamics, Inc. v. Arioto* (1968) 69 Cal.2d 525, 530 (Mosk, J., dissenting). In *PG&E*, the Court held that parties may *create* ambiguities in contract terms by introducing extrinsic evidence, including evidence of negotiations that otherwise would be treated as subsumed into the document's text, so long as the contract terms were "reasonably susceptible" to the meaning supported by the extrinsic evidence once that evidence was taken into account. 69 Cal.2d at 37.

But "reasonably susceptible" has not, in practice, provided much of a limit on the use of extrinsic evidence. Add enough testimony of unexpressed intent, and many words can take on meanings far from their normal ones. Enough self-serving testimony can inject ambiguities into almost any "written transaction that appears to contain unambiguous terms." *City of Manhattan Beach v. Superior Court* (1996) 13 Cal.4th 232, 261 (Mosk, J., dissenting).

As a consequence, *PG&E* "casts a long shadow of uncertainty over all transactions negotiated and executed under the law of California." *Trident Center v. Connecticut Gen. Life Ins. Co.* (9th Cir. 1988) 847 F.2d 564, 569 (Kozinski, J.). Judge Kozinski may have exaggerated slightly in declaring that, under *PG&E*, "it matters not how clearly a contract is written, nor how completely it is integrated, nor how carefully it is negotiated, nor how squarely it addresses the issue before the court: the contract cannot be rendered impervious to attack by parol evidence." *Id.* As this case illustrates, however, the actual situation in the lower courts extends nearly so far.

Indeed, what happened here increased uncertainty still more, by allowing parol evidence that did not specifically address the disputed term to become determinative both as to the result and to the identity of the decisionmaker. By treating the scope of the third-party royalty obligation as an issue of fact simply because extrinsic evidence was introduced, the lower courts not only refused to rely on the contract's terms for its meaning, but refused to interpret the contract at all. Instead, the jury interpreted the contract, though only implicitly: the jury did not answer any specific questions about its contract interpretation, but merely chose a winner in the dispute and an amount of damages to award.

Using disputed extrinsic evidence as a basis for turning contract interpretation over to juries not only "undermines the basic principle that language provides a meaningful constraint on public and private conduct" (*Trident Center*, 847 F.2d at 569), but also removes judicial rigor and accountability from the contract interpretation process. In the first of its 1960s decisions loosening the restrictions on parol evidence, this Court nonetheless recognized that contract interpretation, "even though it involves * * * questions of fact, is essentially a *judicial* function to be exercised according to the generally accepted canons of interpretation so that the purposes of the instrument may be given effect." *Parsons v. Bristol Dev. Co.* (1965) 62 Cal.2d 861, 865 (emphasis added) (Traynor, C.J.). As this case demonstrates, however, the injection of parol evidence into a central role in the process of interpretation may take judges out of the equation altogether.

This Court strayed far enough from the mainstream when it permitted parol evidence, at least in theory, to vary the normal operation of contract terms. See *Delta Dynamics, Inc. v. Arioto* (1968) 69 Cal.2d 525, 529 (noting that breach "[n]ormally * * * would give rise to an action for damages," but—despite the lack of limiting language in the contract—remanding for consideration of other evidence that might "preclude[] that remedy"); *Masterson v. Sine* (1968) 68 Cal.2d 222, 232 (Burke, J., dissenting) (noting that, although intent to exclude assignability normally must be in writing, majority had remanded for admission of extrinsic evidence that might provide the exclusion that the parties had not included in their written contract). Thus, contractual terms have no normal meaning so long as a party is willing to offer testimony broadly related to the point, and a court is willing to let a jury decide the entire contract issue whenever there is any, even remotely pertinent, dispute of fact.

When a jury can pick a winner based on its own unexpressed and unexplained contract interpretation, then, literally, "[w]hat is written today may be reconstructed orally tomorrow." *Garcia*, 36 Cal.3d at 440 (Mosk, J., dissenting). "[T]he attorney who negotiated the written contract is allowed to place his interpretation on contract language, a function that should rest exclusively with the trial court." *Id.* As one commentator recently observed, "if every contract were simply the beginning point in a testimonial battle, we would gain little by writing things down." Linzer, *The Comfort of Certainty: Plain Meaning and the Parol Evidence Rule* (2002) 71 Fordham L. Rev. 799, 806. But in practice that is what California contract disputes have become: a "testimonial battle" resolved by a jury as if the interpretation of the underlying document were an afterthought—and in many cases, in the jury room, it likely *is* an afterthought. Unsurprisingly, this regime—where juries determine the meaning of written contracts by picking winners after hearing evidence of each party's actions and intentions apart from what the parties agreed upon and wrote down—has an "untoward effect on the stability of the law of contracts and evidence." *Garcia*, 36 Cal.3d at 440 (Mosk, J., dissenting).

The Court should take this opportunity to take a first step toward restoring stability and predictability to its contract jurisprudence. Ultimately, the written agreement should govern the dispute unless its terms cannot be construed in context to resolve any disagreement, not because evidence outside those terms may cast doubt on their meaning. Much less should juries decide what terms mean based largely, if not primarily, on evidence and argument not contained in the contract itself.

But if this Court declines to rein in the introduction of extrinsic evidence even where a contract could easily be interpreted without it, the Court certainly should limit the *effect* of that evidence by confining the jury to a role as factfinder to resolve disputed credibility issues. Where a disputed issue of fact may affect the interpretation of a contract term, the jury should resolve that issue and that issue alone, leaving the court to perform the interpretive task assigned to it by Code and common law alike.

At most the jury should become involved in the process of contract interpretation only when "the interpretation turns upon the *credibility* of extrinsic evidence." *Garcia,* 36 Cal.3d at 439 (emphasis added) (quoting *Parsons*, 62 Cal.2d at 865). And the jury's role should be confined to resolving the credibility dispute, so that the judge has a definitive set of facts that may guide her interpretation of the contract. "[E]ven when conflicting inferences may be drawn from uncontroverted evidence" (*id.*)—including the facts that have been finally determined by the jury—those inferences, like other inferences drawn in the course of construing a document, are for the judge, who is guided by principles of contract interpretation and whose conclusions are reviewable *de novo*, not for a jury making a black-box determination.

Contract interpretation in some California courts has strayed from a tightly cabined judicial exercise governed by settled principles of document construction in context, to a single, unexplained, yes-no decision by a jury. In that circumstance, Justice Mosk's observation applies with particular force:

> Given two experienced businessmen dealing at arm's length, both represented by competent counsel, it has become virtually impossible under recently evolving rules of evidence to draft a written contract that will produce predictable results in court.

Delta Dynamics, 69 Cal.2d at 532 (Mosk, J., dissenting). Although more substantial revision of this Court's 1960s precedents would be needed to achieve truly "predictable results," the Court can take an important step toward that goal—without the need to modify or overrule any precedents—by confining the jury's role in contract interpretation to the resolution of factual disputes, the sole task for which juries are properly equipped.

CONCLUSION

The judgment of the superior court should be reversed.

Respectfully submitted,

Dated: January 27, 2006

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CERTIFICATE OF COMPLIANCE
WITH CALIFORNIA RULE OF COURT 14(C)

Pursuant to California Rule of Court 14(c), and in reliance in the word count software of the program used to prepare the brief, I certify that the attached Brief of Amici Curiae contains 11,357 words, exclusive of materials not required to be included under Rule 14(c)(3).

Dated: January 27, 2006

Jim Hawley

PROOF OF SERVICE

I, Jim Hawley, the undersigned, declare:

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2. On January 27, 2006, I served the documents named below by causing true and correct copies of the above to be delivered by first-class mail from Palo Alto, California in sealed envelopes with all fees prepaid, addressed as follows:

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I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed by me on January 27, 2006.

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