

The Transactional Lawyer

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Think Twice before Using “Time Is of the Essence”

Asif Saleem

Transactional lawyers often include in written agreements a declaration that “time is of the essence,” to indicate that any delay in performance is material. Such a declaration therefore relates to the concept of material breach, the absence of which is, under the common law of contract, an implied condition to the non-breaching party’s duty to perform.¹ In short, a declaration that time is of the essence is intended to make every delay in performance a material breach, thereby excusing the other party from having to perform its remaining duties.

Although some might think that a “time is of the essence” clause also applies to other types of contractual deadlines, it does not. For example, the clause is irrelevant to an express condition that must be satisfied by a stated date. Consider a ninety-day option to buy property. If the option holder does not timely exercise the option, the option simply expires and it does so regardless of whether the option contract specifies that time is of the essence.² The clause is similarly irrelevant to a delay in performing the last duty in a sequence of performances. That is because proper and timely performance of the last duty is not a condition to any other obligation.³

The problem with a “time is of the essence” clause is that it is either ineffective or overbroad.⁴ Many courts, perhaps most, refuse to treat the clause as conclusive, and instead leave it to the fact finder to determine whether a breach was material even if the parties’ agreement contains a “time is of the essence” clause.⁵ In such

jurisdictions the clause is virtually meaningless. While a few courts do treat such a clause as determinative,⁶ often without much thought or discussion, it is unlikely that the parties really want every trivial delay, or even a lengthy delay in performing a trivial duty, to be a material breach. Moreover, because the clause applies to a breach by either party, it is unlikely that the party drafting the agreement really intends for its own delays in performance to always be a material breach.

Of course, because it is not always easy for the parties or the fact finder to determine if a breach – and, more specifically, a delay in performance – is material, it is often desirable for the agreement to provide guidance on that issue. But rather than doing so in a broad stroke with a “time is of the essence” clause, which might not be effective, a transactional lawyer should carefully delineate the duties for which timely performance is essential. The following clause should work. It might be wordier than a simple “time is of the essence” clause, but because it is clearer and more specific, it is more likely to be effective.

Material Breach. Any failure to perform, or any delay in performing, an obligation in [specified sections of the agreement] is a material breach, which discharges⁷ the non-breaching party’s remaining obligations under this Agreement, other than those specified in [sections of the agreement].

Note, the sections of the agreement referenced in the second set of brackets should cover each duty – such as duties of confidentiality and indemnification – that are to survive termination of the agreement.

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Notes:

1. See [RESTATEMENT \(SECOND\) OF CONTRACTS §§ 237, 238](#). Technically, the Restatement refers to “material failure of performance”; a material breach could be a significant breach of a minor provision, but such a breach does not excuse the other party’s performance.

2. See, e.g., *Langer v. Bartholomay*, [745 N.W.2d 649](#), 657-58 (N.D. 2008) (citing numerous sources).

3. The clause is also probably too vague to make consequential damages for delay reasonably foreseeable, and hence recoverable. *See* Hadley v. Baxendale, 9 Exch. 341 (1854).

4. In this respect, the clause suffers from the same problem as a typical severability clause, which states that “if any provision of this Agreement is held invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions of this Agreement will remain effective.” *See* Nick Fay, *The Unintended Consequences of a Severability Clause*, [3 THE TRANSACTIONAL LAWYER](#) 3 (Dec. 2013).

5. *See, e.g.*, Kodak Graphic Communs. Can. Co. v. E. I. du Pont de Nemours & Co., [640 F. App’x 36](#), 38 (2d Cir. 2016); Found. Dev. Corp. v. Loehmann’s, [788 P.2d 1189](#), 1201 (Ariz. 1990) (ruling that a “time is of the essence” provision is merely one factor to be considered when determining if a breach is material); Nash v. Superior Court, [150 Cal. Rptr. 394](#), 397 (Cal. Ct. App. 1978), *overruled on other grounds*, Malcolm v. Superior Court, [629 P.2d 495](#) (Cal. 1981); RESTATEMENT (SECOND) OF CONTRACTS § 242 cmt. d & ill. 9 (stock phrases such as “time is of the essence” do not necessarily make every delay in performance a condition of the other party’s performance); 3A CORBIN ON CONTRACTS § 713 at 356 (1951); WILLISTON ON CONTRACTS § 43:7 (4th rev. ed. 2002).

6. *See, e.g.*, Gaia House Mezz LLC v. State Street Bank and Trust., [720 F.3d 84](#), 94 (2d Cir. 2013) (applying N.Y. law and citing to N.Y. authorities to support its statement that “[t]he Agreement included a time-is-of-the-essence clause, which rendered the deadlines material”); Grace v. Nappa, [389 N.E.2d 107](#), 109 (N.Y. 1979) (ordinarily, the law gives a vendor and vendee a reasonable time to perform their respective obligations; but if their agreement contains a declaration that time is of the essence, each party must tender performance by the specified time); TrueStar Petroleum Corp. v. Eagle Oil & Gas Co., [323 S.W.3d 316](#), 319-20 (Tex. Ct. App. 2010). *See also* Gelley v. Park Pleasant, Inc., [494 F. App’x. 187](#), 189 (3d Cir. 2012) (“[t]ime is not of the essence in a contract unless it is specifically so provided or unless the circumstances clearly indicate that it was the intent of the parties”); Brasby v. Morris, [2007 WL 949485](#) at *3-4 (Del. Super. Ct. 2007) (suggesting that a “time is of the essence” clause would make delay in performance material).

7. If the parties wish a material breach to merely suspend, rather than discharge, the non-breaching party’s remaining duties, this language should be modified.



Secured Parties Still Need to Be Aware of Patent Rights in Goods

**John F. Hilson &
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The United States Supreme Court’s decision in *Impression Products, Inc. v. Lexmark International, Inc.*¹ should provide some comfort for secured parties and the lawyers who advise them; but not too much comfort. Caution is still needed before lending against inventory manufactured pursuant to a patent, particularly if the debtor is a manufacturer.

The *Lexmark* case involved a claim of patent infringement against a reselling buyer of printer cartridges that Lexmark had manufactured. Lexmark sold some cartridges at full price and free of restrictions on resale and reuse. It sold other cartridges at a discount but subject to restrictions on resale and reuse. The restricted cartridges had a microchip that made them inoperative if they were refilled. Impression bought restricted cartridges, allegedly with knowledge of the restriction, altered or removed the microchip, and then refilled and resold them. Lexmark sued for patent infringement.

The district court had ruled that Lexmark’s initial sale exhausted its patent rights pursuant to the so-called “first-sale doctrine.” The Federal Circuit reversed.² It acknowledge the existence of the first-sale doctrine, but concluded that a sale made under a clearly communicated, otherwise-lawful restriction as to post-sale use or resale does not confer on the buyer – or on a subsequent purchaser with knowledge of the restriction – the authorization to engage in the use or resale that the restriction precludes.³ The decision created a potential problem for secured lenders. A secured party is not normally bound by the debtor’s *contractual promises* to third parties that limit the debtor’s rights to use or sell the collateral.⁴ The circuit court’s decision did not alter that rule but, by preserving and extending a patentee’s *patent rights* in goods sold to the debtor, it subjected a secured party that knew of and violated those patent rights to statutory damages and injunctive relief, even if the patentee had no provable damages under contract law.⁵

The Supreme Court, in a near unanimous decision, reversed the circuit court. In so doing, the Court adopted an expansive view of patent exhaustion: “a patentee’s decision to sell a product exhausts all of its patent rights in that item, regardless of any restrictions the patentee purports to impose,” and “[t]he purchaser and all subsequent owners are free to use or resell the product

just like any other item of personal property, without fear of an infringement lawsuit.”⁶

The Court’s decision is good for secured parties that finance distributors or retailers that have purchased patented goods. Even if the patentee has imposed restrictions on the borrower’s resale of the goods – such as by limiting sales to a specified geographic area or to transactions in the ordinary course of business – the borrower would be free – as a matter of patent law, not contract law – to ignore those restrictions. More important, the secured party would not, when enforcing its security interest, be bound by those restrictions. Any disposition of the inventory by the secured party that did not comply with those restrictions would not violate the patentee’s patent rights because those rights will have been exhausted by the patentee’s prior sale of the goods. Moreover, the secured creditor will not be in privity of contract with the patentee, and thus, presumably, will have no contract liability for breach of the restrictions.⁷

It bears emphasizing that *Lexmark* does not prohibit patentees from restricting their buyers’ resale or reuse of the goods by contract. As a result, if a borrower purchases patented goods pursuant to a contract that imposes restrictions on resale or reuse, and if the borrower breaches those restrictions, the borrower might have undisclosed liabilities that will affect its creditworthiness and, indirectly, affect the likelihood of repaying the secured lender. Nevertheless, that risk is far less significant than the risk of subjecting the secured party to patent liability if it were to dispose of the goods.

Unfortunately, related but different risks survive. The Court was quite clear that the doctrine of patent exhaustion applies only when the patentee sells patented goods. It does not apply when the patentee licenses its patent rights.⁸ As a consequence, if a secured lender is financing a manufacturer – rather than a distributor or retailer – and if that manufacturer has made goods subject to a patent license, the secured lender needs to be cognizant of what restrictions are imposed in the patent license. For example, a prohibition on sale in specified geographic areas or to specified types of buyers would not only limit the borrower’s ability to sell the goods, but could also apply to a disposition of the goods by the secured lender. Any unauthorized sale of the goods will expose the seller – whether the borrower or the secured lender – to liability for patent infringement.

Moreover, the risk of patent infringement exists even if the license does not impose a restriction on resale or reuse. If the borrower breaches the patent license (e.g., by failing to pay license fees), that breach might result in the termination of the license. In such a circumstance, the borrower might lose all rights to sell the goods, such that

any sale would also be an infringement of the patentee’s patent rights. Unless the secured party obtains an independent right or license directly from the patentee, the secured party’s right to dispose of the goods would be subject to the same patent limitations. A security interest in goods that cannot be sold, either by the borrower or by the secured party, is not a very valuable security interest.

Finally, secured lenders and the transactional lawyers who advise them should note that the *Lexmark* decision does not deal with a situation in which the borrower is the owner of the patent rights. In such a case, the secured lender should consider whether it needs a security interest in the patent itself. Irrespective of whether the patent is available as collateral, the secured lender should consider having the borrower grant the secured lender, in the security agreement, a royalty-free license to use the patent in connection with any post-default disposition of the goods.

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Notes:

1. [137 S. Ct. 1523](#) (2017).
2. [816 F.3d 721](#) (Fed. Cir. 2016).
3. [Id. at 750](#).
4. See U.C.C. §§ 9-406, 9-408.
5. With possible treble damages for a willful violation. See [35 U.S.C. § 284](#).
6. [137 S. Ct. at 1529](#).
7. It also seems unlikely that the secured party conducting a disposition of the goods would – even if it knows of the restriction – be liable for tortiously interfering with the patentee’s contract rights. However, if instead of conducting a disposition, the secured party instructed or advised the debtor to use or sell the goods in a way that violated the patentee’s contract rights, the result might be different.
8. In the words of the court:
A patentee can impose restrictions on licensees because a license does not implicate the same concerns about restraints on alienation as a sale. Patent exhaustion reflects the principle that, when an item passes into commerce, it should not be shaded by a legal cloud on title as it

moves through the marketplace. But a license is not about passing title to a product, it is about changing the contours of the patentee's monopoly: The patentee agrees not to exclude a licensee from making or selling the patented invention, expanding the club of authorized producers and sellers. Because the patentee is exchanging rights, not goods, it is free to relinquish only a portion of its bundle of patent protections.

[137 S. Ct. at 1534.](#)



Be Careful for What You Ask in a Receiver

Stephen L. Sepinuck

The recent decision in *BMO Harris Bank v. Truland Systems, Corp.*¹ provides a valuable lesson for lawyers representing a secured lender or mortgagee that wants a receiver appointed to manage collateral.

The facts are fairly simple. About seven weeks after the debtor filed a Chapter 7 bankruptcy petition, BMO Harris Bank obtained relief from the stay to take charge of specified collateral and to seek the appointment of a receiver. A few days later, the bank got a federal district court to appoint a receiver. The bank then entered into a management agreement with the receiver which, among other things, obligated the bank to pay some receivership expenses and required the receiver to obtain the bank's consent to the use of cash collateral. A dispute then arose between the receiver and the bank; the receiver wanted to pursue an arbitration proceeding but the bank did not wish to fund it. The bank therefore exercised its rights to terminate the management agreement.

That left the court's order appointing the receiver as the only document governing the receiver's authority. The order was silent on the use of cash collateral, so the court concluded that the bank's consent was not needed. The receiver could, in the exercise of his business judgment, use the bank's cash collateral to cover the expenses of arbitration. In short, the bank surrendered the protection for cash collateral in § 363(c)(2) of the Bankruptcy Code when it sought and obtained relief from the stay. The bank then surrendered the similar protection in its management agreement when it terminated the agreement.

Secured parties and mortgagees that seek the appointment of a receiver should learn from the bank's mistake in this case. They should either: (i) endeavor to include in the court order appointing the receiver a prohibition on using cash collateral without the consent of the secured party or mortgagee;² or (ii) include in their management agreement with the receiver a similar restriction on the use of cash collateral, along with a declaration that such restriction survives termination of the agreement.

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Notes:

1. [2017 WL 2864947](#) (E.D. Va. 2017).
2. Even the newly drafted [Uniform Commercial Real Estate Receivership Act](#), already enacted in at least two states, does not have an express protection for cash collateral. Unless the appointment order provides otherwise, the receiver may use receivership property in the ordinary course of business. *See* § 12(a)(2). In addition, with court approval, the receiver may use receivership property other than in the ordinary course of business. *See* § 16(b). Neither provision requires the consent of a secured party with a security interest in cash collateral.



Recent Cases

SECURED TRANSACTIONS

In re SemCrude, L.P.,
[2017 WL 3045889](#) (3d Cir. 2017)

The security interests of the debtor's oil suppliers were unperfected because: (i) even though the U.C.C. of the suppliers' states – Texas and Kansas – contained non-uniform language purporting to provide the suppliers with an automatically perfected security interest, the law of the jurisdiction where the debtor was located governs (even pursuant to the choice-of-law rules in the suppliers' jurisdictions); (ii) that law did not provide for automatic perfection, and (iii) the suppliers did not file a financing statement in the state where the debtor is located. The exception from the scope of Article 9 in § 9-109(c)(3) for security interests "created" by the government did not apply because the non-uniform language merely enabled the debtor to create the security interest by buying the oil.

Oakland Police & Fire Ret. Sys. v. Mayer Brown, LLP,
[2017 WL 2791101](#) (7th Cir. 2017)

The law firm representing the debtor and which provided transaction documents to counsel for the creditors' agent, resulting in the filing of termination statements for a \$1.5 billion term loan that was not paid off, had no liability to the creditors because the firm owed no duty to the creditors. It did not matter that the firm represented the agent in unrelated matters or that it had prepared the documents.

BANKRUPTCY

In re Xurex, Inc.,
[2017 WL 3084400](#) (Bankr. E.D. Mo. 2017)

The prepetition payments the debtor made to an insurance premium financier that had a security interest in unearned premiums were insulated from avoidance by § 547(c)(1) because the unearned premiums exceeded the debt at all times and the financier refrained from exercising its right to cancel the policy in exchange for the payments.

LENDING & CONTRACTING

Cherokee Funding LLC v. Ruth,
[2017 WL 2774377](#) (Ga. Ct. App. 2017)

Because a litigation financing transaction created no recourse obligation, the financier was a buyer of a portion of the litigation proceeds, not a lender, and thus the transaction was not subject to the Georgia Industrial Loan Act or the Georgia Payday Lending Act.

In re 8110 Aero Drive Holdings, LLC,
[2017 WL 2712961](#) (Cal. Ct. App. 2017)

An increase in a loan's interest rate from 5.997% to 10.997% after default was an invalid penalty rather than an enforceable liquidated damages clause. The higher rate was not an alternative performance but applied only after breach. The agreement had numerous other provisions to protect the lender from the added perils and overhead costs in the event of default, including funding reserve accounts, late charges, and a broad indemnity clause, and thus the increase in the interest rate was not a reasonable measure of the lender's damages.

PNC Bank v. Innovative Dental Group, LLC II,
[2017 WL 2345626](#) (N.D. Ill. 2017)

The attorney's-fee clauses in a promissory note and guaranty, by expressly applying "whether or not there is a lawsuit," were broad enough to cover the fees lender's counsel generated by engaging in negotiating and preparing loan modifications prior to the borrower's final default, which resulted in litigation and a judgment.

Ha Thi Le v. Lease Finance Group, LLC,
[2017 WL 2915488](#) (E.D. La. 2017)

Even if a lease of equipment located in Louisiana would be treated as a sale with a security interest under the law of New York, a clause in the lease agreement selecting New York as the forum for all litigation was not enforceable because it violated fundamental policy of Louisiana, as expressed in the state's Lease of Movable Act, that invalidates a consent to jurisdiction in another state or a fixing of venue.

Burcham v. Ford Motor Credit Company, LLC,
[2017 WL 2773697](#) (S.D. Ill. 2017)

Although it was not clear whether the debtor's class action against the secured party for failing, pursuant to a state statute, to timely release its security interest on purchased vehicles was subject to the arbitration clause in the parties' agreement – which excepted actions to "enforce the security interest" – the issue of arbitrability was for the arbitrator because the agreement contained a "delegation provision" indicating that the arbitrator was to decide "the arbitrability of any issue."



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