

Demand for Adequate Assurance of Performance Under the UCC

By John R. Trentacosta & Steven R. Fox

Introduction

During the recent economic downturn, many companies have found themselves questioning whether their contractual partners would be able to perform as expected. Although such questions were of less concern just a short time ago, today many businesses are feeling less confident about the contracts they formed in the better economic times of the 1990s. Because of changes in the economy, they now wonder how to protect their interests in the event of a contractual breach that, although likely to take place, has yet to occur.

More often than not, these companies find themselves grappling with the risks and rewards of their first reaction, which is to treat the contract as repudiated by their struggling partners.¹ A party who treats its contract as repudiated, instead of waiting for an affirmative breach by its partner, generally does so to cut its losses as it seeks out more financially stable contractual relationships. This tactic is often a logical and beneficial move in the “battle before the breach.”²

Unfortunately, a party who decides to act on the repudiation dilemma may later be faced with dire consequences.³ After deciding to treat the contract as repudiated, a party will be faced with one of two basic consequences: (1) the party may be correct in its decision concerning repudiation and may, in fact, be entitled to damages from its faltering partner, or (2) the party may be found to have acted prematurely, thus failing to establish there was a contractual repudiation. In the latter case, the party that wrongfully declared a repudiation may be found liable for damages as the breaching party.

So what does a company do at crunch time when it is clear, at least to them, that the other party to a critical commercial contract likely will not achieve a future performance milestone? Is repudiation the only tool? Fortunately, the Uniform Commercial Code (UCC)⁴ offers what is tantamount to a safe harbor in the risky world of repudiation of commercial contracts. UCC 2-609 provides:

(1) A contract for sale imposes

an obligation on each party that the other’s expectation of receiving due performance will not be impaired. When reasonable grounds for insecurity arise with respect to the performance of either party the other may in writing demand adequate assurance of due performance and until he receives such assurance may if commercially reasonable suspend any performance for which he has not already received the agreed return.

(2) Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards.

(3) Acceptance of any improper delivery or payment does not prejudice the aggrieved party’s right to demand adequate assurance of future performance.

(4) After receipt of a justified demand failure to provide within a reasonable time not exceeding 30 days such assurance of due performance as is adequate under the circumstances of the particular case is a repudiation of the contract.⁵

There are numerous benefits associated with the use of UCC 2-609. By permitting an insecure party to demand assurances and suspend its own performance, the insecure party may reduce its financial expenditures in situations in which the expected returns would make those expenditures fruitless. For example, suspending performance allows an insecure party to save on overhead such as labor costs that would otherwise not be recoverable. At the very least, UCC 2-609 provides nervous parties with a means to seek some measure of peace of mind concerning their contract partner’s ability or inability to perform.

While UCC 2-609 has many upsides, it also presents several risks.⁶ For example, just because a party subjectively worries

about its contract partner's ability to perform does not mean that a court will find that the beliefs were reasonable.⁷ Before suspending its performance, a party must ensure that it has a commercially reasonable basis for demanding assurances.⁸ One may not make demands on a whim. As a federal district court judge stated, "the drafters of the Code did not intend that one party to a contract can go about demanding security . . . whenever he gets nervous. . . . Some reason for the demand . . . must precede the demand."⁹ As discussed in this article, a party seeking to use UCC 2-609 must take a number of factors into account before demanding assurances of performance from its partner. If the demanding party does not take an objective look at its fears, and thereby fails to act on a commercially reasonable basis, a court may find that the demanding party breached by suspending its performance.

Not only must the insecure party's demand for assurances be reasonable, the party must act reasonably when deciding whether the assurances it receives are adequate. If the assurances given are not adequate under UCC 2-609(4), the demanding party may treat the contract as repudiated by its partner. However, if a court later determines that the assurances given were adequate, then the demanding party will be liable for repudiating the contract. Therefore, before treating any contract as repudiated, a demanding party must ask, "what are the minimum kinds of promises or acts on the part of the [partner] that would satisfy a reasonable merchant in [my] position that [my] expectation of receiving due performance will be fulfilled?"¹⁰

Although there are few published opinions analyzing UCC 2-609,¹¹ the existing opinions evidence that courts support both the express language and the principles behind UCC 2-609. In fact, some courts and commentators have even encouraged the application of UCC 2-609 principles to contracts that are not covered by the UCC.¹² This view is recognized in §251 of the *Restatement (Second) of Contracts*. Comment a of §251 justifies the application of UCC 2-609 principles to contracts not covered by the UCC by stating that "the principle that the parties to a contract look to actual performance, 'and that a continuing sense of reliance and security that the promised performance will be forthcoming when due, is an important feature of [every] bargain.'"¹³

Before jumping into the world of repudi-

ation of contract, one must consider using the important tool available under UCC 2-609. However, both the benefits and the risks associated with UCC 2-609 must be contemplated. To do this, two important questions must be addressed: (1) is this feeling of insecurity reasonable? and (2) were the assurances that I received an adequate response to my reasonable demand for assurances?

Reasonable Grounds for Insecurity

Courts decide whether a party has "reasonable" grounds for insecurity on a case-by-case basis, and unfortunately, there is no bright-line rule to resolve this question. Reasonable grounds may arise in many settings and do not have to stem solely from the actions of a contracting party.¹⁴ How then should a party decide whether it has reasonable grounds to demand assurances in the first instance?

A few courts have presented analysis and outlined factors to consider in determining whether a party has reasonable grounds for insecurity. For example, the Sixth Circuit, in *By-Lo Oil Co v ParTech, Inc*, recently focused on these factors: (1) whether the demanding party had little time to make alternate arrangements for performance; (2) the amount of time it would take the demanding party to implement the assurances sent by the party on whom the demand was made; (3) whether the party on whom the demand was made had proved unreliable in the past; and (4) whether the demanding party had reason to believe that the other party would be unable to perform.¹⁵ Similarly, the Arkansas Supreme Court, in *Ford Motor Credit Co v Ellison*, stated that a court should take into account "(1) the nature of the . . . contract; (2) the repetition . . . of conduct that caused insecurity in other transactions; (3) insecurity . . . in the performance of other contracts unrelated legally to the contract at issue; (4) expanding use of a credit term by [the party causing insecurity]; and (5) reputation and rumors concerning the stability and conduct of the party upon whom demand is made."¹⁶

In *By-Lo Oil Co*, the plaintiff, By-Lo Oil, purchased computer software systems from ParTech, Inc., and contracted for continuing service to those systems. In 1997, By-Lo wrote to ParTech and demanded "a written response from [ParTech] by January 31, 1998 of ParTech's commitment that the software [By-Lo] own[s] will function after December 31, 1999."¹⁷ On January 30, 1998, ParTech

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replied to By-Lo that it had not decided what steps would be necessary to ensure that the software would work following Y2K but that By-Lo would be notified immediately following any decision.

By-Lo was not satisfied with ParTech's response and sought additional assurances in person. To this, ParTech simply reiterated the position stated in its earlier letter. Unsatisfied, By-Lo purchased new computer equipment and software from another company. By-Lo sued ParTech for repudiating the contract, and ParTech filed a counterclaim for breach.

The Sixth Circuit held in favor of ParTech, finding that By-Lo did not have reasonable grounds for insecurity and that ParTech's assurances were adequate as a matter of law. The court found that By-Lo's basis for insecurity was that "ParTech was due to perform (in two years) and if ParTech failed to perform, it would be costly to By-Lo."¹⁸ The court dismissed this as a viable reason for insecurity because the risk of non-performance and resulting cost were no different than the case in any commercial contract.¹⁹ The court found that the continuing support provision, in conjunction with ParTech's failure to return phone calls, may have given rise to insecurity at some point but that there was no reasonable basis for insecurity nearly two years before Y2K.

The court found that By-Lo's insecurity was unreasonable because By-Lo had not had any problems with ParTech's prior service.²⁰ Further, By-Lo was not in a time crunch to obtain a new computer system. There was no indication that ParTech would be unable to correct its software or that it would take a lengthy period of time to make any necessary corrections.²¹ Because By-Lo's only basis for insecurity was ParTech's initial delay in response, there was little reason for By-Lo to be concerned two years before the Y2K deadline. Accordingly, the court found for ParTech.²²

In contrast to *By-Lo*, the Eastern District of Michigan found reasonable grounds for insecurity in *Easco Corp v Perkowski*.²³ In this case, Easco brought an action to enforce guarantees executed by Perkowski. Easco sold products to Perkowski's company, and the company failed to pay. Easco refused to make further shipments until outstanding invoices were paid. Perkowski then guaranteed payment of the company's debt. After Perkowski failed to make the payments, Easco refused to ship further goods. Easco sued for the account balance, and Perkowski claimed that Easco breached

by refusing to make its shipments. The court found that arrearages in the company's account gave Easco reasonable grounds for insecurity under UCC 2-609, specifically comment 3.²⁴

Arrearages in a party's account will not, however, always provide reasonable grounds for insecurity. In *Cassidy Poddell Lynch, Inc v SnyderGeneral Corp*,²⁵ the Third Circuit found that SnyderGeneral Corp., a manufacturer of industrial air-conditioning systems, was not justified in seeking assurances from Cassidy Poddell Lynch, Inc., the distributor of SnyderGeneral's products. SnyderGeneral refused to deliver goods after Cassidy failed to make payments for deliveries within 30 days as required by its contract.²⁶ The parties' course of performance demonstrated that payments consistently were made approximately 90 days after shipment.²⁷ The court found that, due to their course of performance, SnyderGeneral was not justified in making a demand for assurances before the expiration of the 90-day period. The unreasonableness of SnyderGeneral's demand was demonstrated by its acquiescence in the 90-day period in the past, the fact that Cassidy was making payment to SnyderGeneral for other shipments, and the fact that Cassidy appeared to be able to pay for the disputed shipment.²⁸ Because SnyderGeneral did not have a reasonable basis for its insecurity, the court held that SnyderGeneral had breached the contract by refusing to deliver the contract goods to Cassidy.²⁹

While SnyderGeneral's course of performance negated its grounds for insecurity, the lack of a written contract was the basis for insecurity in *CL Maddox, Inc v Coalfield Servs, Inc*.³⁰ In this case, Coalfield Services contracted to demolish a facility at CL Maddox, Inc.'s mine and to fabricate and install a new facility. Maddox and Coalfield agreed to payment and progress terms, but the contract was never signed by Maddox. Despite this, Coalfield commenced performance. Coalfield repeatedly asked Maddox to sign the contract but did not receive a response.³¹ Fearing it would not be paid under the contract, Coalfield halted its performance and refused to continue until Maddox signed the agreement. In response, Maddox submitted a contract to Coalfield that included a liquidated damages provision that would result in extensive costs to Coalfield no matter how expeditiously it performed.³² Coalfield refused to continue work following this submittal.

The Seventh Circuit found that Coalfield

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was excused from performance because it had reasonable grounds for insecurity. These grounds included Maddox's failure to make any progress payments and failure to respond to Coalfield's request to sign the contract.³³ Furthermore, the court found that Maddox's demand for a liquidated damages clause, which was unlikely to be accepted, evidenced that Maddox did not intend to perform.³⁴

Advice on Reasonable Insecurity

As these cases demonstrate, a party must take many factors into account when deciding whether it has reasonable grounds to demand adequate assurance of performance under UCC 2-609. An incorrect determination may result in the demanding party, which fears its contract partner's inability to perform, being held in breach for suspending its own performance. To combat this risk, a demanding party should look at the circumstances particular to its contractual relationship as well as outside circumstances when making and ultimately justifying its decision.

Because the courts decide whether a party's insecurity was objectively reasonable on a case-by-case basis, there can be no black letter law concerning what constitutes "reasonable" insecurity. However, the courts seem to have repeatedly adopted several factors in varying forms. Applying the factors described above, an insecure party should feel confident in demanding assurances if it does not believe that the other party will be able to perform. However, a demanding party must thoroughly investigate these circumstances and cannot merely rely on gut feelings or the statements of others.³⁵ Thorough investigation by the demanding party will provide stronger grounds for its decision and encourage a court to find that the party's grounds for insecurity were reasonable.

Adequate Assurances

As discussed above, a party may demand assurances of performance from its contracting partner and suspend its performance when it is faced with reasonable insecurity.³⁶ However, the demanding party will continue to face risks even after it has cleared the "insecurity" hurdle. First, the demand made must be reasonable. As the Seventh Circuit stated, "Section 2-609 is a protective device . . . ; it is not a pen for rewriting a contract . . ." ³⁷ However, "[t]he mere fact that assurances demanded . . . necessitate action beyond that required by the contract

does not render the demand unreasonable as a matter of law."³⁸ As a result, "all demands for adequate assurance call for more than was originally promised . . . [I]t is the very purpose of 2-609 to authorize one party to insist upon more than the contract gives."³⁹

Second, after receiving the purported assurances from its contract partner, the demanding party must determine whether those assurances are adequate. If the assurances received are adequate, the demanding party will be obligated to perform under the contract. If the assurances received are inadequate, the demanding party may treat the contract as repudiated.⁴⁰ However, if the demanding party suspends its performance and the court later finds that the assurances given were adequate, the demanding party will be the breaching party.

In *By-Lo Oil Co*, the Sixth Circuit found that the assurance given by ParTech was adequate. The court noted that "[g]enerally, when a promisor's assurance is something less than what was sought, courts find the assurance inadequate."⁴¹ The court went on to state, however, that it "should keep in mind the reputation of the promisor, the grounds for insecurity, and the kinds of assurances available."⁴²

The court found that ParTech's assurance that it was investigating the matter was adequate despite the fact that it was less than requested by By-Lo. The court listed several reasons for finding the assurance adequate, including (1) that By-Lo did not have reasonable grounds for insecurity, (2) that the Y2K problem was still two years off, (3) that ParTech had never failed any obligations in the past, (4) that ParTech's reputation did not give By-Lo any cause for concern, and (5) that there was little else that ParTech could have done at that time.⁴³

In contrast, in *Land O' Lakes, Inc v Hanig*,⁴⁴ the Iowa Supreme Court held that the assurances given by Hanig, a grain producer, to Land O' Lakes, a grain cooperative, were inadequate as a matter of law. Land O' Lakes was concerned over the effect of poor market conditions on its hedge-to-arrive contracts. Because of this concern, it adopted a policy that required its contract partners to either terminate their contracts subject to a cancellation fee, deliver grain by a certain date, or perform some combination of the two.⁴⁵ On receipt of the policy, Hanig repudiated his contracts with Land O' Lakes and disavowed their enforceability.⁴⁶ The repudiation gave Land O' Lakes reasonable grounds for insecurity, and Land O' Lakes

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sought assurances from Hanig that he would perform. Hanig stated that he intended to perform, but only if a court found the contracts enforceable.

The court found Hanig's assurance of performance inadequate because "Hanig did not promise performance; he promised performance only if the contracts were determined to be enforceable."⁴⁷ Because Land O' Lakes could not be assured of performance until a judgment by the court, it was impossible for the assurance to occur within 30 days, as required by UCC 2-609.⁴⁸ Furthermore, Hanig's assurance was conditioned on a requirement not within the terms of the contract. Therefore, Hanig's assurance was not only inadequate, it was actually deemed a repudiation under UCC 2-610. The court cited the following comment to UCC 2-610: "when a party states its intention not to perform 'except on conditions which go beyond the contract,' the party's statement constitutes a repudiation of the contract" and when "a party's 'assurances' constitute a repudiation, they cannot, as a matter of law, qualify as adequate assurances."⁴⁹

Advice on Adequate Assurances

Before demanding assurances or treating a contract as repudiated, a party must take an objective look at its actions, fears, and requests. If a party demands too much, a court may hold that it has breached the contract. Therefore, a party must be sure to tailor its demands to the actual expectations that it had at the time of contracting, not to the opportunities presented by subsequent reflection.

Likewise, a demanding party who treats the contract as repudiated by its partner may find itself liable for breach if the assurances received are later held adequate by the court. The demanding party must consider several factors when assessing the adequacy of the assurances provided, including what steps its partner reasonably could have taken, whether the assurances added conditions to the partner's obligation to perform, when the partner's performance was due, and the performance of its partner in the past.

Conclusion

Declaring that a party to a contract has repudiated that contract is a risky decision. While the use of UCC 2-609 also presents some risks, it is a useful tool to force the issue of a possible future breach into the open. By applying UCC 2-609 in a responsi-

ble and reasonable manner, a party may protect its interests, plan for the future, and secure its relationship with its contracting partner.

NOTES

1. MCL 440.2610. Under the doctrine of repudiation or anticipatory breach, if, before the time of performance, a party to a contract unequivocally declares the intent not to perform, the innocent party has the option to either sue immediately for the breach of contract or wait until the time of performance. See *Paul v Bogle*, 193 Mich App 479, 493-494, 484 NW2d 728 (1992). In determining whether a repudiation occurred, it is the party's intention manifested by acts and words that controls, not any secret intention that it might hold. See *id.*

2. See, e.g., *Stanton v Dacille*, 186 Mich App 247, 463 NW2d 479 (1990) (defendant liable to plaintiff after repudiating land purchase agreement).

3. See, e.g., *UMIC Gov't Sec Inc v Pioneer Mortgage Co*, 707 F2d 251 (6th Cir 1983) (defendant liable after wrongly treating contract for transfer of mortgage certificates as repudiated by plaintiff); *Stoddard v Manufacturers Nat'l Bank*, 234 Mich App 140, 593 NW2d 630 (1999) (defendant liable after wrongly treating stock sales agreement as repudiated by plaintiff); *Adams v Edward M Burke Homes, Inc*, 14 Mich App 578, 166 NW2d 34 (1968) (plaintiff unable to recover down payment because it wrongly treated purchase agreement as repudiated by defendant).

4. MCL 440.1101 et seq.

5. MCL 440.2609.

6. While not discussed in detail in this article, UCC 2-609 may also limit a party's ability to treat a contract as repudiated after demanding adequate assurances. While this may make a nervous company feel "boxed in" by its decision to demand assurances, this fear seems more perceptual than real. Demanding assurances, in effect, simply delays the same result one would get from an actual repudiation—immediate damages—yet it provides greater protection to the demanding party because the grounds necessary for making such a demand are less stringent.

7. See, e.g., *UMIC Gov't Sec, Inc; Stoddard; Adams*.

8. See *UMIC Gov't Sec, Inc; Stoddard; Adams*.

9. *Cole v Mehin*, 441 F Supp 193, 203 (SD 1977).

10. 2 *Hawkland Uniform Commercial Code Series* 2-609:03.

11. For example, Michigan state courts have only mentioned UCC 2-609 in passing in *Bandit Indus, Inc v Hobbs Int'l, Inc*, No 201781, 1999 Mich App Lexis 2761 (Nov 30, 1999) (unpublished), *rev'd and remanded*, 463 Mich 504, 620 NW2d 531 (2001) (referencing UCC 2-609 to determine meaning of "assurance" as used in personal guarantee).

12. See, e.g., *Norton Power Partners v Niagra Mohawk Power Corp*, 110 F3d 6 (2d Cir 1997) (long-term contract to purchase electricity); *CL Maddux, Inc v Coalfield Servs, Inc*, 51 F3d 76 (7th Cir 1995) (services contract); *Markowitz & Co v Toledo Metro Hous Auth*, 608 F2d 699 (6th Cir 1979) (lease agreement); *Conference Ctr, Ltd v TRC—The Research Corp of New Eng*, 189 Conn 212, 455 A2d 857 (1983) (constructive eviction); *Lo Re v Tel-Air Communications, Inc*, 200 NJ Super 59, 490 A2d 344 (1985) (contract to purchase radio station); see also Farnsworth, *Farnsworth on Contracts* 491-495 (1990).

13. *Restatement (Second) of Contracts* § 251, comment a (1981) (quoting UCC 2-609 comment 1).

14. See *By-Lo Oil Co v ParTech, Inc*, No 00-1148, 2001 US App Lexis 11402, **16 (6th Cir May 30, 2001) (unpublished); *Top of Iowa Coop v Sime Farms, Inc*, 608 NW2d 454, 467 (Iowa 2000).

15. See 2001 US App Lexis 11402, at **17-18.

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16. 334 Ark 357, 363, 974 SW2d 464, 467-468 (1998).
17. 2001 US App Lexis 11402, at **5.
18. *Id.* at **16.
19. *See id.*
20. *See id.* at **17-18.
21. *See id.*
22. *See id.* at **20.
23. No 86-0316, 1987 US Dist Lexis 15431 (ED Mich Apr 16, 1987) (unpublished).
24. *Id.* at *8 (citing MCL 440.2609 comment 3, which states that "a buyer who falls behind in his account with the seller . . . impairs the seller's expectation of due performance").
25. 944 F2d 1131 (3d Cir 1991).
26. *See id.* at 1147.
27. *See id.*
28. *See id.* at 1148.
29. *See id.*
30. 51 F3d 76 (7th Cir 1995).
31. *See id.* at 77, 79-80.
32. *See id.* at 78.
33. *See id.* at 80.
34. *See id.*
35. *See, eg, Ford Motor Credit Co v Ellison*, 334 Ark 357, 974 SW2d 464 (1998) (holding that demanding party's reliance on statements by police was inadequate grounds for insecurity).
36. *See* MCL 440.2609(1).
37. *Pittsburgh-Des Moines Steel Co v Brookhaven Manor Water Co*, 532 F2d 572, 582 (7th Cir 1976).
38. *Top of Iowa Coop*, 608 NW2d at 469.
39. *Id.*
40. *See* MCL 440.2609(4).
41. 2001 US App Lexis 11402, at **20.
42. *Id.* at **21.
43. *See id.*
44. 610 NW2d 518 (Iowa 2000).
45. *See id.* at 520.
46. *See id.* at 521.
47. *Id.* at 523.
48. *See id.*
49. *Id.* at 523-524 (however, insecure party may demand something more than promised in contract under UCC 2-609, but Hanig was not insecure party).

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