

Fighting Off Demands for Adequate Assurances

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Good news: you have an ongoing contract for the sale of goods that is economically rewarding to your company. Bad news: in this down economy, the other contracting party and its lawyers are looking for creative ways to escape from this contract. In New York, one threat is the demand for adequate assurances under Section § 2-609 of the New York Uniform Commercial Code (U.C.C.), which 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.

If successful, the party making the demand will be excused from its remaining obligations under the contract. Unfortunately, these demands are sometimes met with a shrug and an "I will get to that later." Wrong. In order to preserve your contract rights—in particular where you have

negotiated favorable terms—it is important that you: (1) respond quickly, (2) attack the grounds for any claimed need for "adequate assurances," (3) provide adequate assurances (but without creating new demands that ruin the economics of your deal), and (4) assert your legal rights in the event that the other side seeks to terminate the contract on this basis.

In order to defend your (good) contract, it is important to understand the purpose of N.Y. U.C.C. § 2-609. This provision "rests on the recognition of the fact that the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit and that a continuing sense of reliance and security that the promised performance will be forthcoming when due, is an important feature of the bargain."¹ "If either the willingness or the ability of a party to perform declines materially between the time of contracting and the time for performance, the other party is threatened with the loss of a substantial part of what he has bargained for."² Therefore, Section 2-609 provides the mechanism for commercial merchants to address situations when one party has *reasonable* doubts about the other party's ability to perform its contractual obligations.

Section 2-609 involves a two-step analysis: First, a determination as to whether the complaining party has reasonable grounds for insecurity; and second, if so, whether the assurances so provided are

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adequate to assuage the complaining party's concerns. It also requires a prompt response.

Do Not Delay In Your Response

Section 2-609(4) requires a party receiving a "justified demand" to provide adequate assurances "within a reasonable time not exceeding thirty days . . ." The failure to do so "is a repudiation of the contract." Of course, if the demand is not "justified"—i.e., the party making the demand did not have reasonable grounds for insecurity—then the contract is not repudiated. But why chance it? Moreover, if the demand is justified, failure to timely respond may waive the ability to provide adequate assurance.

The first piece of advice is simple: respond within the 30 day period.

Attack the Other Sides' Basis for Claiming Reasonable Grounds for Insecurity

Let's be clear: the UCC does not permit every party to a contract to demand adequate assurances whenever it wants; to do so would be commercial madness, with parties making unreasonable demands to try to get out of their legitimate contractual obligations. Rather, a party demanding adequate assurances must establish that it has "reasonable grounds for insecurity." Unfortunately, there is no "bright-line" test for when a party has reasonable grounds for insecurity; rather, it "depends upon various factors, including the [seller's] exact words or actions, the course of dealing or performance between the parties, and the nature of the sales contract and the industry."³ "What constitutes reasonable grounds for insecurity in one case might not in another."⁴ A determination of reasonable insecurity is based on commercial, rather than legal, standards.⁵

The first point in any response should be that New York courts require a high standard for demonstrating reasonable grounds for insecurity.⁶

That high standard reflects that this section of the U.C.C. is subject to misuse by parties wishing to escape contracts with unfavorable terms. As noted in the Commentary to Section 2-609:

In working out the application of this section, courts will face the necessity of resolving two sharply conflicting interests: (1) The danger to one party of future breach by the other; (2) The danger that parties who wish to escape from a contract obligation may make an unfounded claim that their "expectation of receiving due performance" has been "impaired", and use the powers conferred by this section to weaken the security of contractual undertakings. This possibility of such abuse might indicate that courts would be cautious in applying this section of the Code.⁷

Accordingly, "[c]ourts are given broad discretion in applying § 2-609 to guard against 'flagrant use of 2-609 as a weapon to avoid unprofitable contracts.'"⁸

Nevertheless, courts will find based upon the facts that there is in fact a reasonable basis for insecurity. On one end of the spectrum of reasonableness is a case where a mere false rumor about a buyer's financial stability was sufficient to give rise to the seller's insecurity. The Commentary to N.Y. U.C.C. § 2-609 cites *Corn Products Refining Co. v. Fasola*⁹ as an example of reasonable insecurity:

In that case a contract for the sale of oils on 30 days' credit, 2% off for payment within 10 days, provided that credit was to be extended to the buyer only if [her] financial responsibility was satisfactory to the seller. The buyer had been in the habit of taking advantage of the discount but at the same time that [she] failed to make [her] customary 10 day payment, the seller heard rumors, in fact false, that the buyer's financial condition was shaky. . . . Under this

Article the rumors, although false, were enough to make the buyer's financial condition "unsatisfactory" to the seller under the contract clause.¹⁰

Explained another way, "[w]hat is critical is not so much the objective truth of the facts or events purporting to give rise to the insecurity, but the insecure party's reasonable belief that they are or could be true."¹¹ "If the information comes from a reliable source, a party is under no duty to investigate the accuracy of the information before making his demand for assurances"¹² Therefore, in *Corn Products*, the combination of the false rumor of the buyer's financial instability, along with the buyer's change of commercial practice in not taking advantage of the 10-day payment discount, was reasonable grounds for the seller to feel insecure about its contract with the buyer.¹³

Toward the other end of the spectrum is a case in which numerous facts gave rise to a party's feeling of insecurity, such that the court made a determination of reasonable insecurity as a matter of law. In *Turntables, Inc. v. Gestetner*,¹⁴ the Appellate Division of the Supreme Court of New York, First Department, found that the seller had reasonable grounds for insecurity "even though his suspicion that [the buyer] was insolvent may have been inaccurate."¹⁵ The Court noted that the seller had numerous bases for insecurity regarding its sales contract with the buyer: the buyer owed the seller for goods previously delivered; the buyer's showroom was actually a telephone answering service; the buyer's factory belonged to someone else, and the buyer did not have a key to the premises; the buyer did not lease space; the buyer had no employees, payroll, machinery, or equipment; the seller was advised by another supplier that the buyer was delinquent on payment; and the buyer had a bad reputation for performing and paying.¹⁶

Because this is a "fact-sensitive" analysis, it is difficult to give advice that will apply in every

situation. Nevertheless, the first part of any response to a demand for adequate assurances should question the basis for the alleged insecurity, pointing to the high standard for such demands and the U.C.C.'s general distaste for using a demand as a strategy for escaping an unprofitable contract. Other factors to consider (where applicable) include: (1) the prior course of dealings between the parties; (2) the general ability of the party receiving the demand to pay or deliver the goods; and (3) whether the alleged insecurity is based upon something easily disprovable.

Provide Adequate Assurances, but Don't Go Overboard

"What constitutes 'adequate' assurance of due performance is subject to the same test of factual conditions" as to what constitutes reasonable grounds of insecurity. N.Y. U.C.C. § 2-609, Official Comment 4. One court has noted that "the [party demanding assurances] must exercise good faith and observe commercial standards; his satisfaction must be based upon reason and must not be arbitrary or capricious."¹⁷

The party invoking Section 2-609 does not have unfettered discretion to reject the assurance provided by the responding party. Any rejection of the assurances offered must be based on reasonably exercised discretion. Accordingly, assurances may be less than demanded and still be adequate. One leading commentator has noted that "[a]ll demands for adequate assurance call for more than was originally promised under the contract, and that is precisely what 2-609 authorizes."¹⁸ The pertinent inquiry is as follows:

The question to be answered is: "what are the minimum kinds of promises or acts on the part of the promisor that would satisfy a reasonable merchant in the position of the promisee that his expectation of receiving due performance will be fulfilled?" Generally, when "a promisor's assurance is

something less than what was sought, courts find the assurance inadequate. . . ." In evaluating the assurance, a court "should keep in mind the reputation of the promisor, the grounds for insecurity, and the kinds of assurance available."¹⁹

As noted in the *By-Lo* case, the reputation and course of conduct of the responding party are key factors to a court in assessing the adequacy of its assurances.

For example, where the buyer can make use of a defective delivery, a mere promise by a seller of good repute that he is giving the matter his attention and that the defect will not be repeated, is normally sufficient. Under the same circumstances, however, a similar statement by a known corner-cutter might well be considered insufficient without the posting of a guaranty or, if so demanded by the buyer, a speedy replacement of the delivery involved.²⁰

Conversely, in situations where the commercial relationship between the parties has been strained by the bad behavior of the responding party, courts will require the responding party to do everything it can to assure the demanding party. *Creusot-Loire International, Inc. v. Coppus Engineering Corp.*²¹ is instructive. In *Creusot-Loire*, the court found that the assurances demanded by the plaintiff were reasonable in light of defendant's behavior. Specifically, the court found that defendant failed to respond to plaintiff's demand for technical assurances for months, displayed a lack of candor with plaintiff, and previously delivered non-conforming goods to a different buyer.²² Accordingly, plaintiff's demands for a letter of credit and an extension of the warranty and guarantee were reasonable, and defendant's assurance that the goods would work as promised was inadequate.²³ Simply stated, because defendant's behavior gave significant grounds for insecurity, it should have done more to assure the plaintiff.

What you should do depends upon the facts at issue. However, there is a balancing approach here: try to offer something that—to a reasonable person—would provide adequate security, without subjecting your company to obligations that render the contract economically not viable.

Assert Your Rights

Remember the adage "sometimes the best defense is a good offense." If you believe the other contracting party has breached its obligations under the contract, say so and provide whatever notification of such breach is required under your contract. Why? First, it will help support your argument that the other side has no reasonable grounds for insecurity, but rather is using Section 2-609 as subterfuge to try to escape the contract. Second, while New York law is unclear on this point, other jurisdictions have held that a party already in breach cannot seek adequate assurances.²⁴

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¹ N.Y. U.C.C. § 2-609, Official Comment 1.

² *Id.*

³ *Hornell Brewing Co., Inc. v. Spry*, 664 N.Y.S.2d 698, 702 (Sup. Ct. 1997).

⁴ 1 White & Summers, *Uniform Commercial Code* § 6-2, at 376 (5th ed. 2006).

⁵ N.Y. U.C.C. § 2-609, Official Comment 3.

⁶ *See Phibro Energy, Inc. v. Empresa De Polimeros De Sines Sarl*, 720 F. Supp. 312, 322 (S.D.N.Y. 1989).

⁷ *BAII Banking Corp. v. UPG, Inc.*, 985 F.2d 685, 703 (2d Cir. 1993).

⁸ *Id.* at 703. *See, e.g., United States v. Great Plains Gasification Assocs.*, 819 F.2d 831, 834 n.5 (8th Cir. 1987) (affirming trial court's determination that a buyer's demand for adequate assurance from a gas supplier "was

merely a subterfuge to escape its obligations" under the parties' agreement, given that market price of gas had dropped and supplier's nonperformance would confer a benefit, i.e., not having to pay an above-market contract price, upon the buyer), *cert. denied*, 484 U.S. 924 (1987).

⁹ 109 A. 505 (N.J. 1920).

¹⁰ N.Y. U.C.C. § 2-609, Official Comment 4

(emphasis added).

¹¹ Matthew C. Brenneman, Annotation, *Sales:*

What Constitutes "Reasonable Grounds for Insecurity" Justifying Demand for Adequate Assurance of Performance Under UCC § 2-609, 37 A.L.R. 5th 459

(1996).

¹² *Id.*

¹³ *Corn Products*, 109 A. at 505.

¹⁴ 382 N.Y.S.2d 798 (1st Dep't 1976).

¹⁵ *Id.* at 799.

¹⁶ *Id.*

¹⁷ *Puget Sound Energy, Inc. v. Pacific Gas & Electric*

Co. (In re Pac. Gas & Elec. Co.), 271 B.R. 626, 642 (N.D.

Cal. 2002).

¹⁸ 1 White & Summers, *Uniform Commercial Code*

§ 6-2 at 380.

¹⁹ *By-Lo Oil Co. v. Partech, Inc.*, 11 Fed. Appx. 538,

545 (6th Cir. 2001).

²⁰ N.Y. U.C.C. § 2-609, Official Comment 4.

²¹ 585 F. Supp. 45 (S.D.N.Y. 1983).

²² *Id.* at 50.

²³ *Id.*

²⁴ See *United States v. Great Plains Gasification*

Assocs., 819 F.2d 831 (8th Cir. 1987); *Hope's Architectural*

Prods., Inc. v. Lundy's Constr., Inc., 781 F. Supp. 711 (D.

Kan. 1991).