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In Times Like These, How Sure Can We Really Be? The Right to Adequate Assurance

Client Bulletins

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The fact that some of the most successful and long standing companies in American history are filing for bankruptcy protection at an alarming rate is a tell-tale sign that we are operating in unique and difficult times. Businesses have now started to speculate whether the parties with whom they have contracted will actually be able to uphold their end of the bargain. Eighteen months ago a concern like this would have never been an issue.

While nothing outside of full performance will be able to alleviate this concern, one option available for companies who are unsure as to the viability of the other party to the contract is the right to request and receive adequate assurance of the other party's performance, which is codified in Ohio Revised Code § 1302.67 (UCC § 2-609).

The Right to Demand Adequate Assurance

When a party has reasonable grounds for insecurity with respect to the other party's performance under a sales contract, the insecure party may make a written request of the other party that it provide adequate assurance of its performance under the contract on a going forward basis. The party receiving the demand is required to provide adequate assurance of its intended performance under the contract within a reasonable time but in no event more than 30 days after its receipt of the demand request. Meanwhile, the insecure party has the option to suspend its performance under the contract until it receives adequate assurance of the other party's performance, provided that doing so is "commercially reasonable." If the other party fails to provide adequate assurance in a timely manner, that party will be deemed to have repudiated the contract and the insecure party can proceed with a claim for, among other things, breach of contract.

A party's right to demand adequate assurance is based upon the principle that parties to a contract have bargained for the actual performance of that contract. With that said, whether a party actually has reasonable grounds to be insecure about the other party's performance, and what constitutes "adequate" assurance, are factual inquires that depend upon the circumstances surrounding the contract as well as the credibility of the parties involved.

Reasonable Insecurity

What constitutes reasonable insecurity is a malleable concept; however, the following are examples of instances when a party may be found to rightfully have "reasonable insecurity" as to the performance of the other party:

A seller may have reasonable insecurity if a buyer falls behind on its account with the seller, even if the buyer's default is not with respect to the contract in question. In addition, a seller may be

reasonably insecure even if the buyer has not defaulted on an account but has repeatedly requested additional credit or stops taking advantage of an early payment discount that the buyer consistently used in the past.

A buyer may be reasonably insecure with respect to a seller's performance if the buyer learns from a reliable source that the seller is financially unstable and not able to fulfill its obligations under the contract. For example, a buyer of precision parts that learns from an apparently reliable source that the seller has been delivering defective parts to other buyers has reasonable grounds for insecurity if the buyer intends to use the parts immediately upon delivery.

Adequate Assurance

Even if a party has reasonable grounds to be insecure, the adequate assurance that the insecure party requests must also be commercially reasonable. The reasonableness of adequate assurance is also a factual inquiry that is based upon, among other factors, the trustworthiness of the party asked to give the adequate assurance. For example, if a buyer learns that a seller of otherwise good reputation has delivered defective goods to other buyers, the seller's promise that the defect will not be repeated may constitute adequate assurance. If, on the other hand, the seller is known as a "corner-cutter," then a mere promise by the seller of a conforming shipment may be deemed inadequate assurance without the seller providing the buyer with additional assurances, which may take the form of a guaranty or other financial backing such as a letter of credit.

Conclusion

The right to demand adequate assurance is a valuable contractual tool for a company that now finds itself dealing with a financially distressed company. Companies should consult their legal counsel to determine whether invoking this right is appropriate for a particular situation and what type of assurance may be adequate for the circumstances at hand.

Additional Information

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