



Back to Basics: Fundamental Contract Strategies and Remedies in the Age of Economic Armageddon

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Introduction ■ ■ ■

America is experiencing its worst economic crisis since the Great Depression. The domestic automotive original equipment manufacturers (“OEMs”) have been forced to pursue extraordinary measures to survive – if only on an interim basis. These circumstances dictate that suppliers now be especially vigilant in their dealings with the OEMs. This article focuses on certain fundamental contract considerations for suppliers to the OEMs, which are also generally applicable to sellers in other commercial situations.

I. Reclamation ■ ■ ■

Both federal and state law provide a seller the opportunity to seek recovery of goods sold to a buyer upon ascertaining that such buyer was insolvent at the time of the transaction. Reclamation provides the potential for the safe return of such goods to the seller, subject to certain limitations.

Requirements

Under Michigan law, a seller is entitled to pursue reclamation if: (i) the seller shipped the goods on credit; (ii) the buyer was insolvent when the goods were received; and (iii) the seller has demanded return of the goods within 10 days of the buyer’s receipt of the goods. MCL § 440.2702. In the event the buyer has misrepresented its solvency within the three months before delivery, the 10 day limitation does not apply. MCL §440.2702.

In the event that a buyer has filed for bankruptcy, the Bankruptcy Code also provides for reclamation. Under the Bankruptcy Code, the seller may seek reclamation if: (i) the seller sold goods to the debtor; (ii) the goods were sold in the seller’s ordinary course of business; (iii) the debtor was insolvent at the time the goods were received; (iv) the debtor received the goods within 45 days before the date of the commencement of the bankruptcy case; and (v) the seller demands in writing return of the goods not later than 45 days after the debtor received the goods or not later than 20 days after the commencement of the bankruptcy case, if the 45 day period expires after the commencement of the case. 11 U.S.C. § 546(c).

Limitations

There are limitations imposed by both state and federal law on the right of reclamation. Under Michigan law, a seller’s right to reclaim goods is subject to the rights of a buyer in the ordinary course of business or other good faith purchasers or lien creditors. MCL §440.2702. Additionally, reclamation of goods is an exclusive remedy. MCL §440.2702. Thus, if the seller is able to reclaim the subject goods, the seller is precluded from seeking other relief, including money damages. Under the Bankruptcy Code, a seller’s right to reclaim goods is subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof. 11 U.S.C. § 546(c).

Considerations and Defenses

The seller must be conscious of the time deadlines associated with a reclamation demand. *See* MCL §440.2702; 11 U.S.C. §546(c). Also, the seller's demand must be adequate and specific. At a minimum, the seller must make a clear statement demanding reclamation, specify the date(s) the goods were received, accurately identify the subject goods, request an inventory of the goods on hand, and request that the goods be segregated until they can be returned. *See In re McLouth Steel Products Corp.*, 213 B.R. 978, 983 (E.D. Mich. 1997). The seller must also be knowledgeable of the state and federal standards for establishing the buyer's insolvency. *See* MCL §440.2702; 11 U.S.C. §546(c). Finally, the seller will face obvious difficulties if the goods are no longer identifiable, or no longer in the possession of the buyer, on the date of the demand. *See In re Dana Corp.*, 367 B.R. 409 (S.D.N.Y. 2007).

II. Demand for Adequate Assurance ■ ■ ■

The essence of a commercial contract is actual performance. Critical to the bargain is obtaining the promised performance when due. 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 contracting party is threatened with the loss of the substantial benefit of the bargain. *See* Comment No. 1 to MCL §440.2609.

Under the Uniform Commercial Code, specifically MCL §440.2609, when reasonable grounds for insecurity arise with respect to the performance by either party, the other party may demand, in writing, adequate assurance of due performance. Until the requesting party receives such assurance, he may, if commercially reasonable, suspend performance. Upon receipt of a demand for adequate assurance, the recipient must provide, within a reasonable time not exceeding 30 days, such assurance of due performance as is adequate under the circumstances of the particular case. The recipient's failure to provide the adequate assurance is a repudiation of the contract. *See* MCL §440.2609.

A demand for adequate assurance, however, is invalid when the assurance requested seeks more than the party making the demand is entitled to under the contract. Any attempt to modify the contract in a demand for adequate assurance invalidates the demand. *See Pittsburgh-Des Moines Steel Co. v. Brookhaven Manor Water Co.*, 532 F.2d 572, 582 (7th Cir. Ill. 1976) and *United States v. Great Plains Gasification Associates*, 819 F.2d 831, 835 (8th Cir. N.C. 1987).

Reasonable Grounds for Insecurity

The requisite "reasonable grounds for insecurity" can include, among other things, (i) defects in performance; (ii) rumors of financial instability; and (iii) late payments. A ground for insecurity need not arise from or be directly related to the contract in question. Outside circumstances may be sufficient. In addition, the late payments do not have to relate to the contract at issue. Comments to the Uniform Commercial Code provide that a

buyer who falls behind in its account with a seller, even though the items involved have to do with separate and legally distinct contracts, impairs the seller's expectation of due performance. *See* Comment No. 3 to MCL §440.2609.

The relevant analysis in determining whether there exist reasonable grounds for insecurity focuses on whether a reasonable merchant in the party's position feels that his expectation of receiving full performance was threatened. MCL §440.2609(2). The grounds that give rise to this belief must have occurred after the contract was in place. *See By-Lo Oil Co. v. Par Tech, Inc.*, 11 Fed. Appx. 538, 544 (6th Cir. Mich. 2001). The question of whether a party has "reasonable grounds for insecurity" is a factual one and must be analyzed in view of all of the facts and circumstances of the particular case. *See Hornell Brewing Co. v. Spry*, 664 N.Y.S. 2d 698, 702 (N.Y. Sup. Ct. 1997). This factual analysis must be determined using commercial standards, as opposed to legal standards. *See* Comment No. 3 to MCL §440.2609.

Suspension of Performance

After a written demand for adequate assurance is sent, the party making the demand may suspend its performance until it receives a response, but only if such suspension is "commercially reasonable." To suspend performance means to hold up performance pending the outcome of the demand and includes holding up any preparatory action. *See* Comment No. 2 to MCL §440.2609.

The party demanding adequate assurance, however, runs the risk of the other party or a third party filing suit, and the potential for a judge or jury determining that the suspension of performance was not "commercially reasonable." If found liable, the party demanding adequate assurance may be responsible for any damages caused by its failure to continue to perform.

Adequate Assurance

In evaluating the adequacy of assurances given, a court should consider: (i) the reputation of the assuring party; (ii) the grounds for insecurity; (iii) the kinds of assurances available; and (iv) any other applicable facts or circumstances surrounding the parties and/or the contract. *See By-Lo Oil Co.*, *supra*, at 545. The standard to be applied by the court in evaluating whether adequate assurance has been provided is the same as that for "reasonable grounds of insecurity," meaning that the analysis is a factual one, not a legal one. *See* Comment No. 3 to MCL §440.2609.

Failure to Provide Adequate Assurance

If the responding party fails to give adequate assurance of due performance under the contract, the demanding party has the option to treat the contract as repudiated, or broken, by the responding party. MCL §440.2609(4). The responding party may, however, cure, or fix, the repudiation by providing the necessary adequate assurances, but must do so before the demanding party acts in reliance upon the repudiation by materially changing his position. *See Carr v. Carr*, 751 S.W. 2d 781, 788 (Mo. Ct. App. 1988). The most common ways of

“acting” on the repudiation include, but are not limited to: (i) giving notice of termination of the contract; and (ii) filing suit for breach of contract.

III. Breach of Contract ■ ■ ■

It is critical for a supplier to understand both the nature of the events which give rise to a breach of contract with an OEM, as well as the consequences and remedies resulting from such a breach. Superior knowledge of a supplier’s rights and remedies associated with a breach of contract could potentially provide a supplier with the option to renegotiate more favorable terms with the OEM.

Breach and Anticipatory Repudiation

Material Breach. Under Michigan law, a breach is actionable only if the breach was material, meaning a breach that substantially defeats the purpose of the agreement or goes to the very heart of the agreement, or can be characterized as a substantial failure to perform.

Anticipatory Repudiation. Anticipatory repudiation of a contract generally occurs when a party to a contract, prior to the time of performance, unequivocally declares his intention not to perform. Mere expression of doubt as to the willingness or ability to perform is generally insufficient to constitute a repudiation of the contract.

Acts Which May Constitute an OEM Breach of Contract. While not intended to be exhaustive, the following items are illustrative of acts which *may* constitute a breach of contract by an OEM: (i) failure to accept or pay for goods in accordance with the contract (MCL §440.2301); (ii) failure to comply with the terms of the contract; (iii) anticipatory repudiation of the contract (MCL §440.2610); and (iv) failure to provide adequate assurances upon request (MCL §440.2609).

Potential Remedies

For Breach of Contract. Once a breach of contract has occurred, the non-breaching party should assess its potential remedies. A seller/supplier may be entitled to: (i) withhold or stop delivery of goods (MCL §440.2705 & 2707); (ii) resell the goods and recover damages (MCL §440.2706); (iii) recover money damages for nonpayment as well as incidental damages (MCL §440.2709 & 2710); and/or (iv) terminate the contract and be excused from future performance.

Several recent decisions from the Eastern District of Michigan (Detroit) have indicated that injunctive relief, as it relates to the automotive industry, may only be available in limited circumstances. Eberspaecher North America, Inc. v. Van-Rob, Inc., 544 F. Supp. 2d 592 (E.D. Mich. 2008) (facing a price increase and potential OEM shutdown, court denied injunctive relief where party’s harm was compensable with money damages); Almetals, Inc. v. Wickeder Westfalenstahl, GMBH, 2008 US Dist Lexis 87403 (E.D. Mich. 2008) (where party

terminated contract for unique metals used in auto industry, court granted injunctive relief because goods were unique and not attainable from another source); Thyssenkrupp-Fabco Corp. v. Heidtman Steel Products, Inc., Unpublished Opinion by Nancy G. Edmunds, Case No. 04-74331(2005) (faced with an increase in steel prices, auto supplier denied injunctive relief for failure to prove goods were unique and unable to be acquired from another source and supplier faced irreparable harm); Key Safety Systems, Inc. v. Invista, SARL, LLC, 2008 US Dist. Lexis 70117 (E.D. Mich. 2008) (injunctive relief granted in part where special material for airbags could not be purchased elsewhere and OEM faced shutdown).

For Anticipatory Repudiation. Upon repudiation of the contract by either party, the aggrieved party has options on how to proceed. These options include: (i) awaiting performance for a commercially reasonable time, or (ii) treating the repudiation as final and resorting to any appropriate remedy for breach. *See* MCL §440.2610.

Strategies and Associated Risks

Strategies. In evaluating a strategy for managing its contractual relationship with an OEM, a supplier may consider the following strategies: (i) determine if the OEM has breached and threaten to suspend performance; (ii) determine if the contract has expired by its terms and suspend performance; (iii) terminate the contract pursuant to its terms; (iv) suggest that the inability to perform necessitates renegotiation; (v) seek declaratory relief for breach; and/or (vi) assert that the contract is illusory and unenforceable (General Motors Corp. v. Steel Dynamics, Inc., Oakland County Circuit Court, Pontiac, Michigan, August 4, 2004; transcript granting Steel Dynamics Motion for Summary Disposition).

Risks. In consulting with its legal counsel, a supplier should assess the following risks prior to implementing any remedial strategy concerning its contractual relationship with an OEM: (i) the OEM may commence suit and seek injunctive relief; (ii) the OEM may pursue “cover” (under MCL §440.2712), as well as consequential damages, for any interruption in an OEM’s production; and/or (iii) the business relationship with the OEM may be irreparably damaged.

Conclusion ■ ■ ■

In these times of historic economic crisis, suppliers should be especially circumspect in monitoring their contractual relationships and potential remedies. Given the heightened stakes and the attendant risks, these contractual assessments and strategic determinations should occur in consultation with qualified legal counsel.

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