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# Adequate Assurance In Contracts

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# Agricultural Law Digest

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## ADEQUATE ASSURANCE IN CONTRACTS

**— by Neil E. Harl***

A recent trial court decision in Iowa[1] involving hedge-to-arrive contracts[2] has focused attention on "adequate assurance" under Article 2 of the Uniform Commercial Code.[3] The run-up in grain prices in late 995 and early 1996 caused some elevators -- which were meeting the margin calls and paying the roll charges -- to become concerned about the ability of the producer involved to perform under the contract and to meet the accrued obligations on the contract. But the way demands for adequate assurance are handled can have important implications for the parties to the contract.

### Facts of the Iowa case

In the facts of the Iowa case,[4] a farmer, Heyes, had signed six contracts with the local elevator, Farmers Cooperative Elevator.[5] In late 1995, as grain prices started to rise and losses began to mount, Heyes offered to close out the contracts for $14,050. The elevator refused the offer. Six months later, when losses had deepened to about $63,000, the elevator's lender, CoBank, which had been supplying funds to the cooperative to meet the margin calls and roll charges, leaned on the elevator. CoBank indicated that it was willing to continue advancing funds but only if the cooperative agreed – (1) to enter into no more deferred delivery contracts that required a futures position on the Chicago Board of Trade except those necessary for settling already existing contracts; (2) to enter into settlements with farmers for less than full recovery value only with CoBank's approval; and (3) to reduce all of its future's positions maintained in conjunction with hedge-to-arrive contracts.[6]

A few days later, the cooperative issued a demand to Heyes (and, apparently, other HTA holders) to provide adequate assurance that the farmer would be able to perform on the contract.[7] The letter to Heyes laid out four options for providing adequate assurance – (1) pay all margin calls and commissions; (2) pay all margin calls and commissions and pay the "average contract price" on all contracts up to a price 50 cents below the futures contract price in the applicable futures month; (3) agree to pay the margins from the date of that agreement until the date of actual delivery; or (4) return a signed copy of the letter agreeing to deliver the grain required by the contracts by December of 1996 -–about six months away.[8] Heyes, through his attorney, responded with a request for additional information and a statement of Heyes' understanding of the original contractual responsibilities and an assertion that Heyes intended to perform under the agreements as originally made.[9] Thereupon, the cooperative refused to allow the contracts to be rolled from July, 1996 to the December, 1996, contract, closed out the July futures position and sued

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for $63,120 representing the margin calls paid to that date by the elevator.[10]

**The court's opinion**

The trial court first concluded that the contracts were not illegal, off-exchange contracts under the Commodity Exchange Act.[11] That continues to be a major concern for contracts calling for the sale of several years of production.[12]

Even though the court said the contracts were not invalid under federal law, the court held against the elevator as to the reasonableness of the demand for assurance.[13] The UCC provision reads as follows:

> "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 that party receives such assurance may if commercially reasonable suspend any performance for which that party has not already received the agreed return."

The UCC provision goes on to state -

"Between merchants the reasonableness of grounds for insecurity and the adequacy of any assurance offered shall be determined according to commercial standards."[15]

> Thus, any request for adequate assurance should come only after there are good, solid grounds for believing that the other party may not perform under the contract.

The cooperative in this case argued three grounds for its insecurity - (1) the rising market price for corn in 1996 (which the court rejected); (2) statements of public officials (apparently the Iowa Attorney General) regarding the potential illegality of the six contracts in question (which the court also rejected); and (3) the farmer's past refusal to purchase herbicide under a "booking" arrangement with the cooperative when the farmer found a cheaper price elsewhere (which the court did not view as providing grounds for a demand for adequate assurance).[16] In rejecting the grounds for invoking the adequate performance provision, the court said the cooperative had worked itself into a financial corner and that the demand for assurance from Heyes was in bad faith. The court concluded that it was the elevator's indebtedness that had caused the demand for adequate assurance. Thus, the elevator was responsible for breach of the contracts; the losses remained with the elevator.

**In conclusion**

The message is clear – anyone feeling insecure should proceed cautiously and with an eye to what the contract calls for before making demands for adequate performance. For contracts between merchants, and the Iowa court determined that both the farmer and the elevator were merchants, demands for adequate assurance must be commercially reasonable.

There are dozens of cases slated for trial over the next several weeks in Iowa alone, not to mention the other states where the hedge-to-arrive contract virus had spread. Moreover, the Commodity Futures Trading Commission commenced agency hearings in Minnesota in early February, 1998. More guidance is expected on the legality of HTAs.

**FOOTNOTES**

1 Farmers Coop. Elevator v. Heyes, No. 23493 (Dist. Ct. for Kossuth County, Iowa, December 23, 1997).

2 See generally 10 Harl *Agricultural Law* § 74.04 (Supp. 1997). See Harl, "Hazards of Hedge-to-Arrive Contracts," 7 *Agric. L. Dig.* 77 (1996); Harl, "Hedge-to-Arrive Contracts: Two Federal Court Cases," 8 *Agric. L. Dig.* 153 (1997).

3 UCC § 2-2609.

4 See n.1 *supra*.

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 Futures Trading Act of 1921, Sec. 4, 42 Stat. 187 (1921). See Harl, "Hazards of Hedge-to-Arrive Contracts, 7 *Agric. L. Dig.* 77 (1996).

12 See Harl, "Hedge-to-Arrive Contracts: Two Federal Court Cases," 8 *Agric. L. Dig.* 153 (1997).

13 Iowa Code § 554.2609 (1997).

14 *Id.*, § 554.2609(1).

15 *Id.*, § 554.2609 (2).

16 Farmers Cooperative Elevator v. Heyes, n. 1 *supra*.

# CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

## ANIMALS

**HORSES**. The plaintiff was a veterinarian who had treated horses owned by the defendant on several occasions. The plaintiff was injured while treating one horse for lameness in a paddock. Another horse, either already in the paddock or after entering the paddock from an adjoining pasture, kicked the plaintiff. The plaintiff sued under theories of negligence or "animal injury liability." The defendant argued that (1) the plaintiff had to show that