

Bruce Nathan, Esq. and Eric Chafetz, Esq.



Can UCC Stoppage of Delivery Rights Trump a Debtor's Secured Lender? The Sports Authority Saga Continues!

Article 2 of the Uniform Commercial Code (“UCC”) grants unpaid goods sellers the right to stop delivery of goods or reclaim goods sold to a financially distressed customer, depending on whether the customer had received the goods. However, reclamation rights have been eviscerated as a result of the enactment of the 2005 amendments to the Bankruptcy Code and prior and subsequent court decisions that have subordinated reclamation rights to a secured lender’s floating inventory lien.

A seller’s stoppage of delivery rights can be far more potent than the more problematic reclamation rights. A recent decision by the United States Bankruptcy Court for the District of Delaware, in *O2Cool, LLC v. TSA Stores, Inc., et al.*, continues to tip the scales in favor of an unpaid seller’s stoppage of delivery rights. The court held that a goods seller’s proper exercise of its stoppage of delivery rights may trump a secured lender’s floating lien on inventory because stoppage of delivery rights—unlike reclamation rights—are not subordinate to a floating lien on a debtor’s inventory.

Unpaid Seller’s Right to Stop Delivery of Goods

An unpaid goods seller can invoke UCC §§2-702, 2-703 and 2-705 to stop delivery of goods to a buyer that is either insolvent or has failed to timely pay its obligations to the seller. A seller can prove insolvency based

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on either an equity or balance sheet definition. A buyer is equitably insolvent when it is unable to pay its debts in the ordinary course of business or as they come due. A buyer is insolvent on a balance sheet basis when its liabilities exceed its assets.

An unpaid goods seller can stop delivery of goods in its possession, in transit, or held by a third party bailee (such as a warehouse). The seller must instruct the carrier, warehouse or other third party not to release the goods to the buyer. While the instruction does not have to be in writing, a prudent seller should deliver a written



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demand to stop delivery to the carrier, warehouse, or other bailee, and concurrently send a copy of the demand to the buyer.

Upon receipt of a stoppage of delivery demand, the carrier, warehouse or other third party must hold and deliver the goods according to the seller’s instructions. As against a buyer, the seller can stop delivery of goods in transit until (i) the buyer received the goods, (ii) the bailee, other than a carrier, acknowledges to the buyer that it is holding the goods for the buyer, (iii) the carrier transporting the goods acknowledges to the buyer that the carrier is holding the goods for the buyer by either reshipping them in accordance with the buyer’s instructions or holding them at the buyer’s warehouse, or (iv) a negotiable document of title for the goods has been issued or negotiated to the buyer.

An unpaid goods seller can stop delivery even where title to or risk of loss with respect to the goods had already passed to the buyer. A seller’s stoppage of delivery rights are also unaffected where the buyer had hired the carrier that picked up the goods or is responsible for paying the shipping charges or insuring the goods. In addition, a buyer’s bankruptcy filing and the resulting automatic stay that would otherwise halt a creditor’s collection efforts do not impact a seller’s ability to exercise its stoppage of delivery rights. A seller’s stoppage of delivery of its goods is also not an avoidable preference.

A seller should proceed carefully when exercising its stoppage of delivery rights following a buyer's bankruptcy filing. The seller should review the court docket in the buyer's bankruptcy case to make sure that no order has been entered that stays the exercise of stoppage of delivery rights. And, except for notifying the carrier or other bailee to stop delivery of its goods, the seller should take no further action to recover its goods without first moving for relief in the bankruptcy court.

Reclamation Rights

Reclamation rights are a state law remedy governed by UCC §2-702(2). An unpaid seller can reclaim goods delivered to a buyer if the goods are sold to the buyer on credit terms; the buyer was insolvent¹ when it received the goods; and the creditor demanded (preferably in a written demand) return of the goods within 10 days of the debtor's receipt of the goods.

According to UCC §2-702(3), a creditor's state law reclamation rights are subject to the rights of a "good faith purchaser." The UCC defines a "good faith purchaser" to include a creditor with a security interest in the debtor's inventory.

Bankruptcy Code §546(c)(1) recognizes a creditor's state law reclamation rights. A creditor can reclaim goods it had sold in the ordinary course of its business on credit to the debtor that were received within 45 days prior to the debtor's bankruptcy filing. The creditor must send the debtor a written reclamation demand identifying the goods not later than 45 days after the debtor's receipt of the goods. If the 45-day period expires after the filing, the creditor has up to 20 days after the bankruptcy filing to send the demand. The reclaiming creditor must also prove the debtor was insolvent based on the balance sheet definition when the goods were received and that the goods were identifiable and on hand when the demand was made. The debtor's sale or other disposition of the goods prior to the reclamation demand defeats a creditor's reclamation rights.

According to §546(c)(1), a reclaiming creditor's rights are subject to the prior rights of a creditor with a security interest in the debtor's inventory. Most courts have held that a lender with a blanket security interest in its customer's inventory has priority over the rights of a reclaiming creditor.

Section 546(c)(1) also states that reclaiming goods is the sole remedy for a creditor that has satisfied the requirements for reclamation. Unlike the prior version of the Bankruptcy Code, §546(c)(1) does not grant creditors alternative remedies, such as an allowed administrative priority claim or a replacement security interest in other assets of the debtor in lieu of reclaiming the goods.

Facts and Procedural History

O2Cool, LLC ("O2Cool") designed, manufactured and distributed pool and beach products. Sports Authority Holdings, Inc. and its affiliates (the "Debtors") purchased O2Cool's goods for sale in retail stores throughout the United States and Puerto Rico. Between January and February 2016, the Debtors purchased \$608,130 of goods (the "Disputed Goods") from O2Cool. The Debtors arranged for their freight for-

warder, Yusen Logistics (Americas), Inc. ("Yusen"), to coordinate the shipment of the Disputed Goods from China to the Debtors' distribution center in Colorado. Yusen then arranged for various carriers, including OOCL (USA), Inc. ("OOCL"), to transport the Disputed Goods.

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Prior to the Debtors' bankruptcy filing, between February 12 and 26, 2016, O2Cool sent Yusen five notices to stop delivery of the Disputed Goods (the "Stoppage Notices"). Yusen acknowledged receipt of the Stoppage Notices, advised O2Cool that they were only acting as the freight forwarder, and indicated that OOCL was the carrier that was transporting the Disputed Goods. O2Cool then sent the Stoppage Notices to OOCL, which also acknowledged receipt. O2Cool also alleged that the Debtors had instructed Yusen and/or OOCL to ignore the Stoppage Notices and instead deliver the Disputed Goods to the Debtors. The Disputed Goods were never returned to O2Cool. The Debtors received the Disputed Goods, sold them to their retail customers and then remitted the proceeds to pay the claims of their pre-petition secured lenders/agents, Wilmington Savings Fund Society, FSB ("WSFS"), Bank of America, N.A. ("BANA"), and Wells Fargo Bank, N.A. ("Wells," and together with WSFS and BANA, the "Lenders").

On March 2, 2016, the Debtors filed voluntary petitions under Chapter 11 of the Bankruptcy Code. On May 3, 2016, the Court entered a final order approving the Debtors' post-petition secured financing arrangement (the "Financing Order"). The Financing Order included a deadline of May 16, 2016 (the "Challenge Deadline") by which parties could challenge the liens, claims and/or security interests of the Lenders (a "Challenge Proceeding").

On June 21, 2016, more than a month after the Challenge Deadline, O2Cool filed a complaint against the Lenders, the Debtors and other parties to obtain a declaration that (i) the Disputed Goods were not property of the Debtors' estates due to the transmittal of the Stoppage Notices, and (ii) O2Cool's rights to the Disputed Goods and all sale proceeds trumped the rights of the Debtors and the Lenders. The Lenders moved to dismiss the complaint based on, among other grounds, a failure to state a claim upon which relief could be granted. The Lenders argued that O2Cool did not have any UCC remedy because O2Cool did not successfully stop delivery of the Disputed Goods prior to the Debtors obtaining possession of the goods. According to the Lenders, the carrier's alleged negligence or willful dishonor of the Stoppage Notices did not matter. Therefore, O2Cool's only UCC remedy was reclamation, which was not exercised, and, even if exercised, would have been defeated by the Lenders' floating inventory lien. O2Cool replied that it did not have to exercise reclamation rights because it had properly exercised its UCC stoppage of delivery rights while the Disputed Goods were in transit and before the Debtors' receipt of the goods.²

The Court's Decision

The court denied the Lenders' motion to dismiss. The court only had to determine whether the complaint included sufficient facts to support O2Cool's stoppage of delivery claim. The court concluded that O2Cool had sufficiently alleged its proper invocation of stoppage rights while the Disputed Goods were in transit and prior to the Debtors' receipt of the Disputed Goods. The court also relied on case law O2Cool had cited supporting its position that the Stoppage Notices were sufficient to prevent the Disputed Goods from becoming property of the Debtors' estates and subject to the Lenders' floating inventory liens. The court further cited Official Comment 6 to UCC §2-705 that "[a]fter an effective stoppage under [§2-705] the seller's rights in the goods are the same as if he had never made a delivery."

The court rejected the Lenders' argument that O2Cool lacked a remedy under the UCC because O2Cool's stoppage of delivery rights, unlike reclamation rights, are not subject to the rights of a good faith purchaser, such as the Lenders with a blanket security interest in the Debtors' inventory. The UCC also does not allow a buyer to sell goods free and clear of a seller's stoppage of delivery rights, unless the seller is paid in full in cash for the goods.

Finally, the court held that O2Cool's complaint was not barred by the Financing Order as a late filed Challenge Proceeding. The Disputed Goods did not become property of the estate assuming the validity of O2Cool's allegation that the Stoppage Notices were issued while the Disputed Goods were in transit. As a result, O2Cool's claims did not either challenge the validity, extent, perfection or priority of the Lenders' security interest in any property of the Debtors or raise any challenge to the Lenders' claims.

Conclusion

The court's ruling is not the end of the story since it was only in the context of a motion to dismiss. While there is no guaranty that O2Cool will ultimately prevail, the holding appears to be a backhanded attempt to press the Lenders and O2Cool to settle. Not a bad result for the trade at the end of the day, but subsequent proceedings still bear watching! ■

1. The definition of insolvency in the reclamation context is the same as for stoppage of delivery.

2. The Lenders also argued that the complaint was untimely because it was filed after the Challenge Deadline.

Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization and Creditors' Rights Group and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, is a former member of the board of directors of the American Bankruptcy Institute and is a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached via email at bnathan@lowenstein.com.

Eric Chafetz is counsel at the law firm of Lowenstein Sandler LLP. He can be reached at echafetz@lowenstein.com.