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Last in Line I

By Jennifer McLain McLemore and Eric J. Monzo

Stoppage Notices Have Chilling Effect on Liens of Secured Creditors

O2Cool *Opinion Revisits UCC Remedy*

Jennifer McLain McLemore
Christian & Barton, LLP
Richmond, Va.

Eric J. Monzo
Morris James LLP
Wilmington, Del.

Jennifer McLain McLemore is a partner with Christian & Barton, LLP in Richmond, Va., and vice chair of the International Women's Insolvency & Restructuring Confederation. Eric Monzo is a partner with Morris James LLP in Wilmington, Del. Ms. McLemore is co-chair and Mr. Monzo is communications manager of ABI's Unsecured Trade Creditors Committee.

On March 1, 2017, the U.S. Bankruptcy Court for the District of Delaware issued an opinion denying three motions to dismiss filed by the debtors' lenders in an adversary proceeding arising out of the *Sports Authority* cases.[1] The lenders sought dismissal of a complaint filed by O2Cool LLC,[2] which sought damages including $608,130 representing the unpaid balance of stopped goods and related relief. The dismissal motions asserted that the complaint was filed after the deadline to file reclamation claims and § 503(b)(9) claims, and after the court-ordered deadline to assert lien challenges pursuant to the final order approving the debtors' debtor-in-possession (DIP) financing.

While the lenders asserted that O2Cool's failure to affirmatively preserve its rights through reclamation or lien challenges should give rise to dismissal of its complaint, O2Cool instead asserted that its rights were preserved, since "stopped goods do not constitute property of the debtors' estates, and that O2Cool's rights in the stopped goods and sale proceeds thereof are [thereby] superior to those of [the lenders]."[3] In denying the motions to dismiss, the court revisited the utility of a Uniform Commercial Code (UCC) stoppage notice and reaffirmed the potential power of such a notice over floating liens and DIP financing liens.

O2Cool's complaint was premised on its assertion that it served a timely and proper UCC § 2-705 stoppage notice on the carrier that was transporting O2Cool's goods to the debtors.[4] The stoppage notice was allegedly delivered by O2Cool to the carrier prior to the debtors taking possession of O2Cool's manufactured goods and prior to the bankruptcy petition date. The complaint also asserted that prior to the petition date, the debtors directed O2Cool's carrier to disregard the stoppage notice, which allowed the debtors to receive O2Cool's shipment from the carrier despite the stoppage notice. After the debtors received the goods, they sold the goods and the sale proceeds were turned over to the debtors' lenders.

Ripeness of the Controversy Under the Declaratory Judgment Act

In considering the motions to dismiss, the opinion analyzed the ripeness of O2Cool's claims under the Declaratory Judgment Act. While the lenders asserted that the complaint was not ripe because

1 The *Sports Authority Holdings Inc., et al.*, cases are jointly administered chapter 11 cases pending in the Delaware bankruptcy court. The main case can be found at Case No. 16-10527.

2 The opinion describes O2Cool LLC as a "designer, manufacturer, and distributor of consumer goods, specializing in pool and beach products." *O2Cool LLC v. TSA Stores Inc. (In re TSAWD Holdings Inc.)*, No. 16-51014-MFW, 2017 Bankr. LEXIS 559, *2 (Bankr. D. Del. March 1, 2017).

3 *Id.* at *1-*2.

4 Section 2-705: Seller's Stoppage of Delivery in Transit or Otherwise states:
(1) The seller may stop delivery of goods in the possession of a carrier or other bailee when he discovers the buyer to be insolvent (Section 2-702) and may stop delivery of carload, truckload, planeload or larger shipments of express or freight when the buyer repudiates or fails to make a payment due before delivery or if for any other reason the seller has a right to withhold or reclaim the goods.
(2) As against such buyer the seller may stop delivery until
(a) receipt of the goods by the buyer; or
(b) acknowledgment to the buyer by any bailee of the goods except a carrier that the bailee holds the goods for the buyer; or
(c) such acknowledgment to the buyer by a carrier by reshipment or as a warehouse; or
(d) negotiation to the buyer of any negotiable document of title covering the goods.
(3)
(a) To stop delivery the seller must so notify as to enable the bailee by reasonable diligence to prevent delivery of the goods.
(b) After such notification the bailee must hold and deliver the goods according to the directions of the seller but the seller is liable to the bailee for any ensuing charges or damages.
(c) If a negotiable document of title has been issued for goods the bailee is not obliged to obey a notification to stop until surrender of possession or control of the document.
(d) A carrier who has issued a non-negotiable bill of lading is not obliged to obey a notification to stop received from a person other than the consignor.

O2Cool needed to first exhaust its remedies against the debtors and the carrier for failing to abide by the terms of the stoppage notice, the court did not find this position to be persuasive. Instead, the court held that O2Cool was harmed under the facts asserted, explaining that O2Cool's asserted damages were not hypothetical, but ripe as to the lenders. O2Cool's question to the court of "whether the Stoppage Notices prevented the Disputed Goods from becoming property of the Debtors' estates such that O2Cool's rights in the Disputed Goods are superior to the rights of the [lenders]" was valid and ripe for consideration.[5] The court further explained that "O2Cool's claims are not premised on a contingency but on a past event, specifically, the service of the Stoppage Notices, which gave O2Cool an interest in the Disputed Goods superior to any interest [of the lenders.]"[6] On this basis, the court declined to dismiss the complaint pursuant to Rule 12(b)(1).[7]

Failure to State a Claim

When analyzing the lenders' Rule 12(b)(6) arguments, the opinion considered the lenders' assertions that O2Cool failed to state a claim due to its failure to file a timely reclamation motion or timely file a § 503(b)(9) claim. The lenders also asserted that because O2Cool failed to file a lien-challenge complaint prior to the deadline, O2Cool also failed to preserve its claims, subjecting them to Rule 12(b)(6) dismissal.[8] The lenders' final Rule 12(b)(6) argument was that even if O2Cool had filed a timely reclamation claim, the lenders' floating lien gave them a "good-faith purchaser" priority lien over O2Cool's reclamation-based claim.

Failure to Seek Remedies Available Through Reclamation Rights and the Lien-Challenge Process

In considering the lenders' Rule 12(b)(6) arguments regarding O2Cool's untimeliness, the court gave credence to O2Cool's argument that its failure to preserve its reclamation rights under the UCC and Bankruptcy Code and its failure to preserve its right to assert lien challenges were irrelevant. The court agreed — in the context of the motions to dismiss — that O2Cool's ownership interest in the shipped goods never transferred to the debtors.[9] The timely stoppage notice and the relevant provisions of the UCC created a scenario where O2Cool did not need to file a reclamation claim, § 503(b)(9) claim or lien challenge proceeding to preserve its interests in the shipped goods or the proceeds thereof.

The reasoning behind this conclusion arises from the court's review of some of the established principles behind a stoppage notice: "If a seller discovers that a buyer is insolvent while its good are in transit, section 2-705 of the UCC permits the seller to stop delivery of any shipment in possession of the carrier."[10] "As a general rule, section 2-705(3)(b) of the UCC provides that after receiving a stoppage notice, the carrier must hold and deliver the goods only according to the seller's instructions."[11] In considering these principles, the court also considered its prior opinion in *Cargill Inc. v. Trico Steel Co. (In re Trico Steel)*.[12]

While factually distinct from the *O2Cool* case, the court reviewed *Trico*'s holding to determine whether O2Cool's complaint was sufficiently pled.[13] The *Trico* opinion explains that "[t]he UCC defines 'receipt' of goods as taking physical possession of them."[14] In the context of a stoppage notice, "'[r]eceipt' must be distinguished from delivery, particularly in regard to the problems arising out of the shipment of goods, whether or not the contract calls for making delivery by way of documents of title, since the seller may frequently fulfill his obligations to 'deliver' even though the buyer may never 'receive' the goods."[15] Further, the "'delivery' of the goods, where risk of loss and transfer of title pass to the buyer, does not necessarily constitute [a] 'receipt' of goods, which requires transfer of actual physical possession."[16] Following *Trico*'s interpretation of the UCC, and under the facts asserted by O2Cool, the debtor may have never actually received the shipped goods such that the lenders' liens never attached, and further, the lenders' liens never attached to the proceeds of the goods when they were sold.

The Priority of the Floating Liens and DIP Financing Liens

Beyond arguments related to whether O2Cool properly preserved its rights in the goods, the lenders also asserted that even with a timely, proper reclamation claim, O2Cool's rights in the shipped goods would have been inferior to the lenders' rights under the terms of the DIP financing order and pursuant to the lenders' pre-petition floating liens on all of the debtors' assets.[17] In considering this facet of the lenders' Rule 12(b)(6) argument, the court explained that while UCC § 2-702(3) "subjects a seller's right to reclaim to section 2-403, which allows the sale to a good-faith purchaser, [t]here is no similar provision subjecting a seller's right to withhold and stop delivery to a sale to a good-faith purchaser."[18] Instead, the UCC permits a "sale by the buyer free and clear of a seller's right to stop delivery" only upon "full payment in cash to the seller."[19] Relying on such analysis, the court could not dismiss the complaint based on the lenders' argument that their pre-petition floating liens and those liens established in the DIP financing order established their priority lien over the stopped goods.

Unpaid Seller's Right to Stop Delivery

The *O2Cool* decision shows how potent a seller's stoppage of delivery rights can be. With both pre-petition floating liens on all collateral and extensive liens established in the DIP financing order, the lenders in *O2Cool* made robust efforts to preserve and protect their interests in the debt-

5 *O2Cool LLC*, 2017 Bankr. LEXIS 559, at *9.
6 *Id.* at *10.
7 *Id.*
8 *Id.* at *12.
9 *Id.* at *15.
10 *Id.* at *12 (citing Del. Code. Ann. Tit. 6, § 2-705(1)).
11 *Id.* (citing Del. Code Ann. Tit. 6, § 2-705(3)(b)).
12 282 B.R. 318 (Bankr. D. Del. 2002).
13 *O2Cool LLC* at *15.
14 *Trico*, 282 B.R. at 323 (citations omitted).
15 *Id.* at 324 (citations omitted).
16 *Id.*
17 *O2Cool LLC* at *16.
18 *Id.*
19 *Id.*

ors' property. The *O2Cool* opinion operates as a reminder to unsecured sellers of goods that under the UCC, if they properly exercise stoppage rights, those rights can function as a lien superior to a floating lien on inventory and superior to a DIP financing lien. UCC §§ 2-702, 2-703 and 2-705 might be used by an unpaid seller to stop delivery of goods to a buyer that is either insolvent or has failed to make a timely payment. The unpaid seller may look to stop delivery of the goods in its possession, in transit or held by a third party (such as a carrier or warehouseman) by providing notice through a stoppage-of-delivery demand.[20] As a general rule, a bailee must hold and deliver the goods in accordance with the seller's instructions after receiving a stoppage notice.[21] This simple UCC-based remedy, if properly executed, can be a powerful tool in the hands of a general unsecured creditor.

Under UCC § 2-702(3), state law reclamation rights remain subject to the rights of a good-faith purchaser, which under the UCC includes a creditor with a security interest in the debtor's inventory. Section 546(c)(1) of the Bankruptcy Code recognizes state law reclamation rights and provides the exclusive remedy for a creditor that has satisfied the requirements for reclamation. However, the *O2Cool* decision supports the proposition that a seller is not required to pursue a remedy through reclamation or lien-challenge proceedings if the seller exercises its stoppage rights before a debtor receives the goods in dispute.[22] If a stoppage notice was issued while the goods in dispute were in transit, the goods do not ever become property of a debtor's estate under the UCC,[23] therefore reclamation is not a suitable remedy to recover stopped goods.

Stoppage-of-delivery rights, unlike reclamation rights, should not be subject to the rights of a good-faith purchaser such as a lender with a blanket security interest in a debtor's inventory. Therefore, under the UCC, a buyer cannot sell goods "free and clear" of a seller's stoppage-of-delivery rights unless the seller is paid in full.

Conclusion

O2Cool shows that if exercised properly, stoppage notices under the UCC might prevent shipped goods from becoming part of a debtor's estate, and such goods can thereby be kept outside of the bankruptcy estate. If the property is not part of the debtor's estate, a lender may not have an interest in the property, even if the lender has a floating lien on the inventory. While it is important to keep in mind that *O2Cool* was only issued in the context of motions to dismiss, when read in conjunction with the *Trico* opinion, clarity can be gleaned regarding the leverage to be obtained by sending a proper stoppage notice under the UCC. While the court did not specifically rule as to whether a seller exercising its stoppage rights prior to the buyer taking physical possession preserves the seller's rights ahead of priority creditors, the implication of these two opinions, when read together, is that such an assertion of fact, if proved, would carry great weight in a bankruptcy proceeding. While the question remains as to whether O2Cool will ultimately prevail in its adversary proceeding, from a trade creditor's perspective the *O2Cool* opinion is favorable and demonstrates the importance of utilizing stoppage notice rights when available under the UCC. abi

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20 *See, e.g., In re Trico Steel Co. LLC*, 282 B.R. 318; *In re Nat'l Sugar Refinery Co.*, 27 B.R. 565 (S.D.N.Y. 1983); *see also Montello Oil Corp. v. Marin Motor Oil Inc. (In re Marin Motor Oil)*, 740 F.2d 220 (3d Cir. 1984).

21 U.C.C. § 2-705(3).

22 Recent decisions interpreting the "received by the debtor" language in § 503(b)(9) of the Bankruptcy Code are instructive to the analysis. Looking to the UCC, the U.S. Court of Appeals for the Third Circuit recently held that "receipt as used in 11 U.S.C. § 503(b)(9) requires physical possession by the buyer or its agent" and "common carriers do not qualify as agents." *In re World Imports*, 2017 WL 2925429, at *5-6; *see also In re SRC Liquidation*, 2017 WL _____ (Bankr. D. Del. July 13, 2017) (affirming objection to § 503(b)(9) claim because goods were not received by debtors).

23 *See, e.g.*, Del. Code. Ann. Tit., 6, § 2-705 cmt. 6 ("After an effective stoppage under this section the seller's rights in the goods are the same as if he had never made a delivery.").