

## **THE DECLINE IN RETAIL IS BECOMING A WAR BETWEEN THE SECURED LENDERS, THE DIP LENDERS, AND THE VENDORS WHO'S GOODS ARE AT ISSUE**

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As part of the *Sports Authority* chapter 11 cases (jointly administered under Case No. 16-10527) pending in Delaware, the Court issued an opinion denying Rule 12(b) motions filed by the pre-petition and DIP lenders to *Sports Authority* seeking the dismissal of an adversary proceeding filed by O2Cool LLC, a vendor of high quality goods to *Sports Authority*. The lenders' dismissal motions asserted several alternative grounds for dismissal of O2Cool's complaint that O2Cool had timely asserted its UCC § 2-705 stoppage notice on the carrier that was transporting O2Cool's goods to the debtors. (See *O2Cool LLC v. TSA Stores Inc. (in re TSWD Holdings Inc.)* No. 16-51014 MFW.)

The dismissal motions asserted that O2Cool had failed to affirmatively preserve its rights through reclamation under the UCC and the Bankruptcy Code and had failed to file a lien challenge. Of course, after O2Cool's stop notice was ignored by the common carrier and the goods were delivered to *Sports Authority*, the goods were sold and the sale proceeds turned over to the debtors' lenders under their pre-petition floating liens and the Delaware Court's DIP lender orders. We have written recently about the rights allowed to vendors who deal with insolvent retailers in prior posts addressing reclamation or lien challenge.

(<http://www.jhindslaw.com/wp-content/uploads/2016/06/Reclamation-Claim-Part1.pdf> and <http://www.jhindslaw.com/wp-content/uploads/2016/06/Reclamation-Claim-Part2.pdf>.) The Delaware's Court's *Sports Authority* opinion on the Rule 12(b) motions sheds a new light on a twist of what we have discussed before.

The Delaware Court's opinion on the Rule 12(b)(6) portion of the lender's Motion gave credence to O2Cool's argument that its failure to preserve its reclamation rights under the UCC and § 503(b)(9) Bankruptcy Code and its failure to preserve its right to assert lien challenges were irrelevant. As a result of O2Cool's assertion of its stoppage rights under the UCC the court conclude that O2Cool's interest in the goods in transit never transferred ownership rights to the debtors. (See *O2Cool LLC v. TSA Stores Inc.* at \*12.) The lenders' argument that once the goods reached the hands of the debtor they automatically became part of the debtors' § 541 estate and thus subject to the lenders' per-petition floating lien rights and then the court's DIP lending order which reserved and enhanced the pre-petition lenders' rights was trumped by the UCC § 2-705 rights afforded to O2Cool's timely stoppage demand.

### **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. In considering this facet of the lenders' Rule 12(b)(6) argument, the Delaware 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." 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." Replying on such analysis, the Delaware Court could not dismiss O2Cool's 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.

Based on the Delaware Court's opinion in the O2Cool matter, stoppage-of-delivery rights under UCC § 2-705, unlike reclamation rights should not be subject to the rights of good-faith purchasers such as a lender with a blanket security interest in a debtor's inventory. *Sports Authority* stands for the proposition that under the UCC, a buyer cannot sell goods "free and clear" of a seller's stoppage-of-delivery notice rights unless the seller is paid in full.

So the final message to our clients and friends is that the O2Cool ruling stands for the proposition that if exercised properly, stoppage notices under the UCC can prevent shipped goods from becoming part of the debtor's estate, being subject to pre-or post-petition lien claims of the lenders, and being sold by the debtor without 100% compensation to the vendor. The exercise of these UCC rights can avoid unnecessary fights in bankruptcy court of title to the goods, passage of rights, and lien perfection.