BANKRUPTCY TRENDS

Dancing Around Workouts: Is it Time for the Article 9 Two Step?

BY RICHELLE KALNIT

Hilco Streambank's Richelle Kalnit explores a transformative approach to restructuring retail and consumer brands facing bankruptcy.

The process of restructuring retail and consumer companies is at an inflection point. First-lien lender recoveries in bankruptcy are decreasing because brands are being sold well after the connection with the customer is lost and valuable ecommerce connectivity is broken.

The challenge is that sale processes for retail and consumer brands are unpredictable, and notwithstanding the best efforts of skilled investment bankers to achieve a going-concern sale, these processes often result in a piecemeal sale of assets, i.e., intangible assets separate and apart from inventory. By the time a sale comes to a head, the intangible assets have been severed from the customer, resulting in lower valuations because buyers deduct from their purchase price the cost to rebuild the brand and re-engage the customer.

It's time to consider a new construct to maximize the value of retail and consumer brands and orchestrate better outcomes.

Stepping in Time: Aligning Article 9 and Bankruptcy

This article proposes that we change the tune when it comes to retail and consumer restructurings, particularly those involving non-residential real estate leases, and adopt the "Article 9 Two Step."[1]

> "In the Article 9 Two Step: (1) the senior lender conducts a public foreclosure sale of the company's intangible assets under article 9 of the Uniform Commercial Code (UCC), and then (2) the senior lender funds a chapter 11 bankruptcy to sell the company's remaining assets and address non-residential real estate lease liabilities, while also allowing a creditors' committee to perform its investigatory and statutory duties."

The Article 9 Two Step goes like this:

Step 1 – Selling the Intangible Assets Through Article 9: Finding a Chair Before the Music Stops: When a senior lender to a retail or consumer brand is in the position of the fulcrum security, rather than selling the intangible assets during or after the store closing process, do that first. Conduct a sale process under article 9 of the UCC of the borrower's intangible assets prior to the bankruptcy filing. Set a bid deadline and provide for a public auction (as opposed to a strict foreclosure[2]), so that the market is canvassed in a fashion nearly identical to a sale under section 363 of the Bankruptcy Code.

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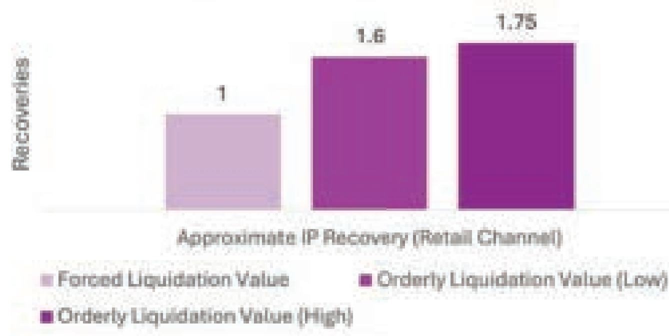
This allows for the parties best positioned to assist in the maximization of the company's intangible assets – its employees – to assist in the sale process. Employees are often the key holders of critical assets such as data and logins for ecommerce sites and social media accounts. Selling these assets prior to bankruptcy increases the likelihood that a brand's ecommerce site will remain operational during and through the sale process and that a buyer will be able to maintain continuity with the customer. Maintaining an uninterrupted relationship with the customer – both through continuous messaging and through an operational ecommerce site and social media channels, each controlled by the buyer – is critical to maximizing value.

It also offers a buyer optionality to assume the senior lender's debt. This could be attractive to a buyer in the event it seeks to conclude the article 9 sale process itself through a credit bid, and allows it to work in tandem with the borrower in the resulting bankruptcy. Furthermore, it allows errant liabilities to be extinguished as part of the bankruptcy, giving comfort to an "as is, where is" buyer in the article 9 sale.

Undoubtedly, there would be certain concessions that would need to be made by a buyer of intangible assets in such a circumstance, such as granting a limited license back to the borrower to allow for the bankruptcy and remaining asset sales and wind-down.[3] However, licenses such as this are regularly granted as part of sales in and outside of bankruptcy and, where the brand buyer has purchased the brand prior to the bankruptcy, it is better positioned to control the terms of the circumstances under which the debtor/borrower may use the name. In addition, this construct assumes cooperation by the borrower/debtor. This is not surprising nor is it different than what would occur in a Chapter 11 liquidation, which is conducted voluntarily by a debtor typically in concert with approval and funding from the lender.

Ultimately, this strategy capitalizes on the substantial difference between forced liquidation value (FLV) and orderly liquidation value (OLV) of retail brands. By orchestrating a pre-bankruptcy sale, stakeholders stand to benefit by potentially



achieving values closer to OLV. While FLV and OLV vary by retail brand based on various factors, the OLV of brands which derive their income from retail channels may see an OLV which can be 60-75% greater than FLV.

Step 2 – When the Music Stops: Maximizing the Value of Remaining Estate Assets Through Bankruptcy: Following the article 9 sale, the borrower would file for bankruptcy in order to sell any remaining tangible assets (often more difficult to sell through an article 9 sale), address lease liabilities (typically incapable of being addressed in an article 9 sale) and to allow for the creditors' committee to conduct its investigation into the liens and claims of the secured lender and into the prepetition activities of the debtor. Much of this theoretically could be done through a Chapter 7 bankruptcy instead of a Chapter 11 bankruptcy, although without financing, a Chapter 7 trustee would have difficulty selling inventory through retail stores.

Until recently, the Article 9 Two Step would have been difficult to achieve given the capital structure of many retail and consumer brands. Senior lenders historically recovered in full, or close to it, even in a Chapter 11 liquidation, leaving the second (or more junior) lien lender as the fulcrum security.

The Rise of Non-Bankruptcy Alternatives, but Rarely in Concert with Bankruptcy

In some respects, with the increase in utilization of non-bankruptcy alternatives, the Article 9 Two Step is not far-fetched. Workout and restructuring professionals are well-aware that alternatives to bankruptcy, such as assignments for the benefit of creditors (ABCs) and receiverships, are being increasingly considered and utilized. However, ABCs are inadequate when it comes to addressing retail lease liabilities except in the rare circumstance where landlords consent to the termination of leases. And receiverships – a creature of state law for which there may not be consistency across states – often require court approval for sale and wind-down activities, similar to a bankruptcy.[4]

The idea is also not implausible because lenders often utilize restructuring support agreements (RSAs) or stalking horse agreements (or both). Setting up an article 9 sale before bankruptcy mimics that, but does not rely on the bankruptcy to achieve the sale of the intangible assets.

In other respects, the Article 9 Two Step is quite novel. When bankruptcy arises in the context of an article 9 sale process, it is typically used to stave off such a process – the lender conducts an article 9 sale process of a borrower's assets following a default, and the dissenting borrower files for bankruptcy to prevent the foreclosure. Bankruptcy is not typically used in tandem with article 9 to maximize value. Retail and consumer brands would be the perfect use case for such a construct.

Article 9 – A Primer

Article 9 of the UCC governs secured transactions, including the foreclosure of collateral by a lender to satisfy a debt. When a borrower defaults on a secured loan, the lender has the right to repossess and sell the collateral.[5] Such a sale must be conducted in a "commercially reasonable" manner.[6]

Why Now?

Adapting the Process to the Changing Capital Structures

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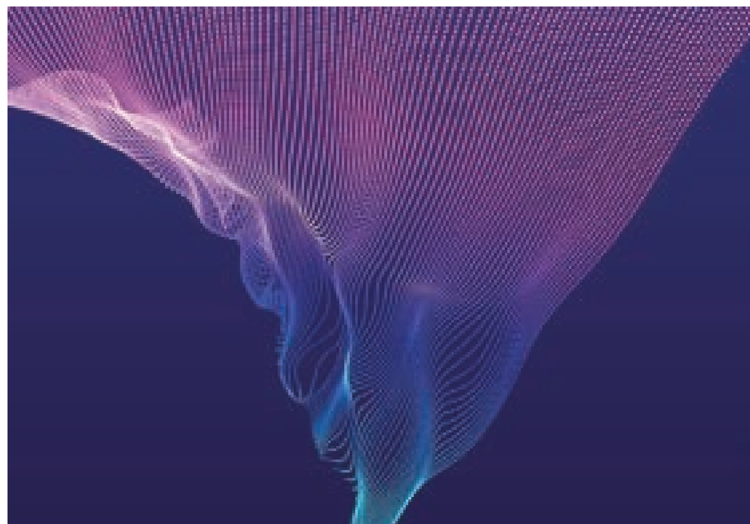
full, or close to it, even in a Chapter 11 liquidation, leaving the second (or more junior) lien lender as the fulcrum security. The senior lender would have had no incentive to conduct this Article 9 Two Step and the junior lender would have had no right to do it, due to typical "silent second" provisions of an intercreditor agreement.

However, as the *Wall Street Journal* reported, recoveries of senior lenders in bankruptcies are decreasing. "For companies exiting bankruptcy so far in 2024, first-lien recoveries have been 50% … compared with an average of 74% in 2021 and 2022."[7] Given this, the time is ripe for senior lenders to consider a two-step process that provides the opportunity to increase recoveries when compared to the bankruptcy single-step.

Adapting the Process to the Evolving Assets

A sale of intangible assets prior to bankruptcy means that it is more likely the employees needed to maximize the value of customer engagement – marketing and ecommerce experts – are employed by the company at the time of the sale. This allows a brand to maintain the relationship with its customer through uninterrupted marketing and ecommerce initiatives, thereby maximizing value. It also alleviates some of the cost of the bankruptcy process by providing for the sale of these assets to take place in a more cost-effective fashion, through an article 9 sale.



A "data dump" will no longer be sufficient. It is already insufficient. Data will need to be transferred from one person with knowledge to a recipient who can communicate with the transferor, and that transferor needs to be well-positioned to transfer know-how and documentation related to that data.

In mergers and acquisitions transactions, data will start to play an increasingly critical role as part of the package of intangible assets, and not just in transactions involving technology or data companies. Ensuring that key company employees as well as customer engagement are maintained will become even more important in this data revolution. Traditional forms of intangible assets such as brands, patents, software and domain names have been supplemented with data. And that data is ever-evolving, going well beyond transaction data to cover artificial intelligence-enabled search preferences and products sampled in virtual and actual dressing rooms, as well as data that contributes to a company's success such as inventory optimization strategies and artificial intelligence prompts utilized as part of its marketing strategy.

The construct proposed in this article allows for a comprehensive transfer both of data and knowledge pertaining to that data. A "data dump" will no longer be sufficient. It is already insufficient. Data will need to be transferred from one person with knowledge to a recipient who can communicate with the transferor, and that transferor needs to be well-positioned to transfer know-how and documentation related to that data. Doing this at the end of a bankruptcy liquidation, when critical employees have often departed, will devalue the data.

While, in theory, the data is typically accompanied by a data dictionary, that term is a misnomer, as the data acquirer may understand what "M" and "F" mean within context (male and female), but may not be able to decipher what "1" and "2" mean without institutional knowledge.

Workout and restructuring professionals will be well-positioned to structure processes that maximize value of this enhanced data, which is what the Article 9 Two Step seeks to achieve.

Potential Challenges to the Two Step and How to Address Them

It would be understandable to raise certain concerns related to the Article 9 Two Step. Three such concerns are addressed here.

One concern could be cost. It could be argued that two legal processes – an article 9 sale followed by a bankruptcy – would be more expensive than one. While the construct envisions two legal processes, this fact alone should not create additional fees. In fact, given that the parties to each step of the process would be the same (lender, borrower), and given that this construct would likely limit the time in bankruptcy, it is more likely to reduce rather than to increase fees.

Another concern could be the use of bankruptcy courts to address liabilities without utilizing them for the benefit of their "free and clear" sale orders under section 363 of the

Bankruptcy Code. Much as it is often stated that bankruptcy should not be used for the sole benefit of a secured lender, would this construct mean that bankruptcy would be nothing more than a vehicle to reject real property leases? Practically speaking, no. The benefits of maximizing value outweigh the costs of the limited use of the bankruptcy court system.

In fact, this construct would alleviate pressure on the courts, which are often overwhelmed during times of economic distress. Moreover, it will allow creditors' committees – whose constituents would be "out of the money" in these transactions (as they assume the first lien lender would be the fulcrum security) to focus on their important investigatory obligations.

Finally, in an article 9 sale, assets are transferred "as is, where is." One might question whether an ongoing operation can be transferred to a buyer using article 9, and whether this would raise issues of possible successor liability. Given that this construct assumes cooperation of the borrower, it is more likely that operating assets would be able to be transferred than in a liquidating bankruptcy, where operating assets are often shut down. While contracts such as those required to maintain ecommerce functionality and customer connectivity may require consent of the counterparty to assign, those counterparties may be more open to assignment by the buyer than being left without the buyer's go forward business, also reducing the likelihood that those parties would argue that the buyer has successor liability.

Coda

As first lien lenders continue to confront diminishing recoveries, putting them in the fulcrum position, and as the next wave of consumer and retail distress comes into focus, secured lenders and workout and restructuring professionals need some new moves.

In restructuring, where timing is everything, it is time to leverage the strengths of both article 9 and bankruptcy as a duet, before the music stops.

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Kalnit has experience in the sale of intellectual property assets on both the sell- and buy-side in bankruptcy, Article 9 foreclosure transactions, out-of-court sale processes, receiverships, and assignments for the benefit of creditors. She works closely with consumer privacy ombudsmen when they are appointed in connection with the sale of personally identifiable information in bankruptcy.

[1] The name of this construct – the "Article 9 Two Step" – is based on the Texas Two Step, a controversial legal maneuver sometimes utilized to address mass tort liabilities in which a parent company utilizes Texas state law to split into two entities, followed by a bankruptcy for the newly created entity holding the mass tort liabilities. Of course, beyond the name, the construct proposed here is very different.

[2] A public auction will also stave off an argument that the intangible assets were sold for less than reasonably equivalent value.

[3] The lead case could be filed under a name that differs from the brand that was purchased out of the article 9 transaction.

[4] *See e.g., In re Aiwa Corp.*, Case No. 21-07702 (July 28, 2021) ("Texas has long held that receiver sales should be confirmed by the court.").

[5] *See* UCC § 9-609.

[6] *See* UCC § 9-610.

[7] *Top-Ranking Lenders See Diminishing Recoveries in Bankruptcy, Wall Street Journal*, May 14, 2024.