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Chapter 11 vs. Out-of-Court Restructuring: Predictions and Strategies

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ABI Winter Leadership Conference 2024

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The following is a general, high-level overview of certain restructuring and/or liquidation options for companies in financial distress. The decision regarding which of the below options to choose is highly case-specific and dependent on the facts and circumstances. The below overview and list of pros and cons are not comprehensive and do not give advice as to any particular situation.

1. Managed Liquidation

A managed liquidation is a process by which the company shuts down its business and liquidates its assets to pay creditors. Unlike the other options discussed below, the company manages the liquidation process itself without the involvement of a third party or court supervision.

Pros:

- A managed liquidation is the cheapest of the options discussed here because it is out-of-court and run by existing management.
- Management is likely to be in the best position to negotiate with landlords, vendors, and other creditors and to understand the company's assets.

Cons:

- If creditors cannot be paid in full or satisfied by negotiated terms, the directors and officers could face personal liability for an inappropriate liquidation and dissolution. As such, a managed liquidation likely will not be appropriate where there are numerous creditors or potential contingent or unknown liabilities.
- Secured creditors may not be willing to permit the company to manage its own liquidation or may demand active participation and oversight by the secured creditors.

2. Friendly Foreclosure

A friendly foreclosure is an out-of-court foreclosure under applicable state laws (i.e., the foreclosure provisions of the Uniform Commercial Code for personal property and applicable state law for real property), in which the company cooperates with the secured creditor to assemble and voluntarily turn over the assets.

Pros:

- A friendly foreclosure allows for the company to have some input into a process where, otherwise, the secured creditor could exercise its lien rights by proceeding through the courts to file a lawsuit seeking foreclosure as a remedy.
- Cooperating in a friendly foreclosure allows the company to negotiate with the secured creditor, for example, for sufficient cash to fund a managed wind-down of the company.

Cons:

- Depending on the manner and terms by which the friendly foreclosure is agreed upon, a friendly foreclosure may expose directors and officers to allegations, especially by aggrieved creditors, of breaches of fiduciary duty and similar claims.
- There are potential claims against the secured creditor for not conducting a “commercially reasonable” foreclosure or for receiving a fraudulent transfer, on the grounds that the assets were sold too cheaply through the foreclosure.
- The secured creditor also may be concerned about successor liability.

3. Assignment for the Benefit of Creditors

An assignment for the benefit of creditors is a state law process by which a distressed company selects an assignee, who is an independent third-party fiduciary, to whom the company assigns its assets, subject to existing liens. In some states, such as California, ABCs are conducted without court supervision. ABCs in other states (such as Delaware) require court filings and may require court approval.

Pros:

- An ABC is usually less expensive, faster, and more flexible than a bankruptcy case.
- The company chooses the assignee, and significant creditors (particularly secured creditors) often can work with the company and the proposed assignee before initiation of the ABC to negotiate the treatment of claims or a sale transaction that is mutually beneficially and incurs less transaction costs than is possible in a bankruptcy case.
- The presence of a third-party fiduciary helps mitigate the risk that aggrieved creditors could sue officers or directors or otherwise challenge a sale made by the assignee.

Cons:

- Aggrieved creditors may still attempt to exercise remedies against the assets or commence an involuntary bankruptcy.
- Unlike in a bankruptcy, the assignee cannot sell assets free and clear of existing liens absent the lienholders' consent, and anti-assignment provisions and ipso facto clauses in contracts and leases remain effective.

4. Receivership

A state receivership is a provisional remedy under state law. In a California receivership action, for example, a court appoints an impartial person (the receiver) to take possession of specific property to prevent its dissipation or deterioration pending the outcome of a lawsuit. A receivership is done at the request of a third party (such as a secured creditor or a litigant).

Pros:

- Consenting to a receivership may allow the company to negotiate to retain some management and control over the business.

Cons:

- Because a receivership is done at the request of a third party and is ordered by a court in connection with litigation, the company's management usually has very little say in the scope of the receivership and loses control of the business and its assets.

5. LMEs

LMEs (Liability Management Exercises) are transactions through which a borrower whose assets are already encumbered can access additional capital.¹ LMEs can take different forms:

- *Uptier Debt Exchange*
 - A distressed borrower accesses new capital by issuing new Superpriority senior secured debt provided by a subset of the borrower's existing senior secured lenders in exchange for their existing senior debt.
 - The remaining existing senior debt is effectively subordinated to the new Superpriority secured debt.
 - Typically, majority lender consent is required to amend the debt documents.
- *Asset Drop Down*

¹ For more information on LMEs, please see AlixPartners white paper on Liability Management attached as Appendix 2.

- In an asset drop-down, a borrower utilizes its availability under restricted investment and transfer “baskets” in loan documents to transfer collateral away from the reach of existing secured parties by transferring the collateral to an entity that is designated as an “unrestricted subsidiary” (which is not an obligor on the existing secured debt).
 - The unrestricted subsidiary then uses the collateral (often intellectual property) to secure new financing.
 - Unlike uptier transactions, majority lender consent is not typically required.
- *Double Dips*
 - A “double dip” involves a secured loan to non-guarantor subsidiary. That borrower subsidiary then transfers the proceeds to an affiliate.
 - The affiliate then issues (i) a secured intercompany note to the non-guarantor subsidiary and (ii) a guaranty on the secured loan, both of which are collateral for the secured loan.
 - The lenders end up with two claims against the affiliate—a claim under the guaranty and an indirect claim under the secured intercompany note.

Pros:

- Distressed companies are able to access much-needed liquidity, and can even get out of existing debt at a discount.
- LMEs have advantages that are attractive to participating lenders, which can
- When all goes right, LMEs can allow a company to avoid bankruptcy, or, at a minimum, avoid a freefall bankruptcy.

Cons:

- Transaction costs for LMEs are very high and therefore likely only practicable for large companies with complicated cap structures, as LMEs will be prohibitively expensive for many companies.
- Focus on LME can distract management and board from operational turnaround.
- LMEs are litigation targets for disenfranchised lenders.
- LME often simply delays the inevitable of a chapter 11 (*see, e.g., Appendix 1*).

6. Chapter 7

In a chapter 7 bankruptcy, a company is liquidated and the proceeds distributed to creditors according to the Bankruptcy Code’s priority rules. A bankruptcy trustee, rather than existing management, is typically appointed and, in almost all cases, shuts down all operations while looking for buyers of the debtor’s assets. The trustee will only “administer” the estate if it can get comfort that there are sufficient unencumbered assets with which to pay his or her fees.

Pros:

- The chapter 7 process is simple and far less expensive than a chapter 11 proceeding.
- Because the chapter 7 trustee will shut down operations (and most costs and damages associated with such terminations will be prepetition unsecured claims), the company's operational expenses will be drastically reduced.
- The directors and officers are insulated from liability for any post-chapter 7 sale terms, even to insiders, because the chapter 7 trustee is the fiduciary responsible for the final wind-down decision.

Cons:

- Where there are secured creditors, a decision to file for chapter 7 will often require the cooperation of secured creditors to "carve out" collateral or otherwise assure the chapter 7 trustee that he or she will be paid.
- In the absence of an assurance of payment, a chapter 7 trustee may abandon the estate to its secured creditors so that they can/must foreclose under applicable state law.
- Recoveries are usually limited.
- The attorney-client privilege will pass to the chapter 7 trustee, which is obliged to look into all assets, including claims against directors and officers. It is not uncommon for aggrieved creditors to encourage (and sometimes finance) the prosecution of such claims.

7. Chapter 11

In a chapter 11 proceeding, a company continues to operate its business as the debtor-in-possession, usually under its pre-existing management. Most bankruptcy courts require that a chapter 11 debtor be able to pay the costs of the chapter 11 proceeding while the matter is pending, which would include its operations (current payroll, leases, etc.), professional fees (counsel, financial advisors, and/or investment bankers) for itself and a creditors' committee, and fees payable to the United States Trustee.

Pros:

- The process of pursuing a sale or reorganization in a chapter 11 case is now well-understood and reasonably predictable.
- Buyers generally prefer chapter 11 sales because of advantages unique to the court process, which include a court order establishing that the sale was "free and clear" of liens and interests, the power to override anti-assignment provisions in most contracts, and the insulation from fraudulent transfer and other related

liability. As a result, a chapter 11 sale will often attract more buyers and somewhat higher pricing than sales in other restructuring/liquidation processes.

- Because the Bankruptcy Court must approve the sale, directors and officers are generally insulated from allegations of breaches of fiduciary duty and other litigation made in connection with the sale and sale process.

Cons:

- As a general rule, a chapter 11 case will be much more expensive than any other restructuring/liquidation alternative.²
- The Bankruptcy Court is a ready-made forum for dispute identification and resolution. An aggrieved party (usually a creditor) has a ready forum to obtain information/discovery and to litigate over allegations of wrongful acts, with the concomitant risks of delay and additional cost.

² For small business debtors that are eligible to file, a subchapter V proceeding offers a more streamlined process that, among other benefits, is usually far less expensive than a traditional chapter 11 case.

Appendix 1

Examples of LMEs that Ultimately Filed for Bankruptcy

J.Crew
iHeart
Neiman Marcus
Caesars
Hornblower
Party City
Revlon
Envision / Amsurg
Amsurg
Wesco
Serta
Robertshaw
Wheels Pro

Example of LMEs in Private Credit

- **Vista Equity Partners (“Vista”) acquired Pluralsight in a take-private transaction in April 2021 at a \$3.5B valuation**
 - The transaction was funded in part with a \$1.2B recurring revenue loan and a \$100MM revolver
 - Pluralsight implemented a drop-down transaction earlier in 2024 pursuant to which it transferred certain intellectual property to a restricted subsidiary with Vista making a \$50MM loan or preferred equity investment (reports differ) to this subsidiary to enable Pluralsight to make an interest payment to its lenders
 - Subsequently:
 - Pluralsight announced an agreement to recapitalize its business with a group of existing lenders led by funds managed by Blue Owl Capital Inc. and including funds managed by Ares Management Corp., Goldman Sachs Asset Management and by Oaktree Capital Management, L.P., among others
 - Under the terms of the agreement, the investor group will own 100% of the company while providing over \$200MM of capital
- **Generally:**
 - Will non-syndicated credit lenders may be reluctant to take aggressive adversarial positions vis-à-vis sponsors upon whom they depend for the next deal?
 - Will middle market sponsors be less willing to take aggressive positions in order to not risk relationships with private credit lenders?
 - Are credit docs really LME proof?
 - What are the bars to creditor-on-creditor violence?

Source: <https://www.goodwinlaw.com/en/insights/publications/2024/08/alerts-privateequity-ma-pluralsight-change-of-control-transaction>

Appendix 2

AlixPartners Liability Management White Paper

AlixPartners

Liability management

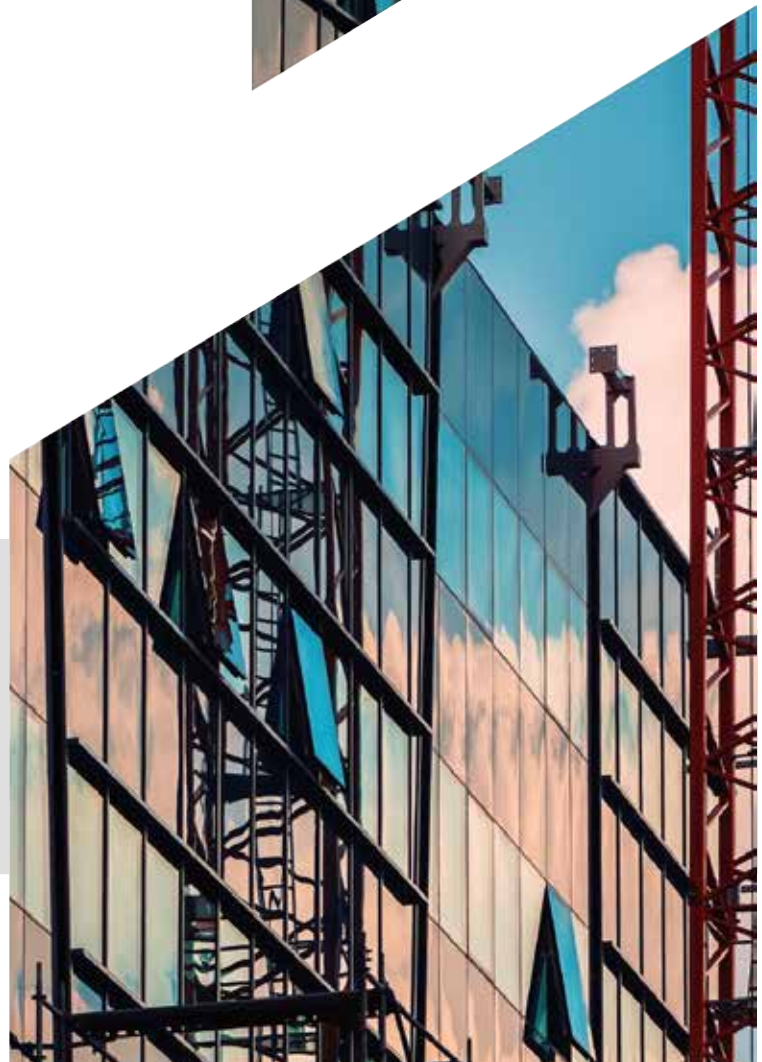
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When it really matters.sm



Liability management is becoming the go-to option for companies in search of a lifeline, looking to capture a discount or seeking to avoid formal restructuring.

Once seen as novel, transactions that leverage flexibility within existing debt documents to create refinancings, unlock fresh capital, and take advantage of other opportunities, are now familiar in the U.S. and no longer uncharted territory in Europe.

With techniques such as the double-dip, drop-down, and uptier exchange becoming well entrenched, the nature of the conversation is changing. Companies and lenders that have made a success of liability management increasingly recognize that securing an extension of runway is not an end in itself. Instead, it is best deployed as part of a holistic exercise that aims to resolve – rather than paper over – the underlying causes of financial pressure as part of a comprehensive turnaround or transformation.

But why the rise in popularity? Is liability management significantly different from other financial management strategies deployed over the years? And how can true business benefits be realized, beyond merely extending maturities and re-carving up an existing capital structure?

Why is liability management on the rise?

In broad terms, Liability Management Exercises (LMEs) see leveraged companies secure fresh capital to support the transformation of the business, at times over the objections of some creditors.

This might involve, for example, the drop-down of assets into an unrestricted subsidiary that issues new debt, or the amendment of financing agreements to permit additional senior debt incurrence. Different transactions will suit different companies, depending on their particular needs, capital structures and stakeholder profiles.

In AlixPartners' 2024 Turnaround and Transformation Survey, we asked turnaround executives what liability management techniques they expect to see activated in the next twelve months:

72%

cited changes to capital structure or movement of assets

40%

anticipated increased monitoring of liabilities and risk

41%

expected creditor co-operation agreements as a response among lenders

26%

pointed to uptier exchange transactions

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Different transactions will suit different companies, depending on their particular needs, capital structures and stakeholder profiles.

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Such exercises often involve the cooperation of at least some existing lenders. Several factors explain existing lenders' willingness to participate, despite the potential for conflict up to and including litigation (particularly in the U.S.) either in connection with the transaction or down the road if more funding is required or an insolvency proceeding subsequently ensues. First, the increased cost, time, and perhaps risks attendant to bankruptcy protection makes out-of-court transactions more appealing. Second, liability management frequently allows participating creditors to improve their position in the capital structure in exchange for providing incremental liquidity, providing greater protection if bankruptcy was to follow. And third, some lenders want to avoid taking ownership of certain distressed businesses.

The benefits for existing equity of liability management are obvious, and significant, too. Raising incremental debt capital while avoiding restructuring permits shareholders to retain all or a substantial portion of the company's equity and buys time for a business to turnaround.

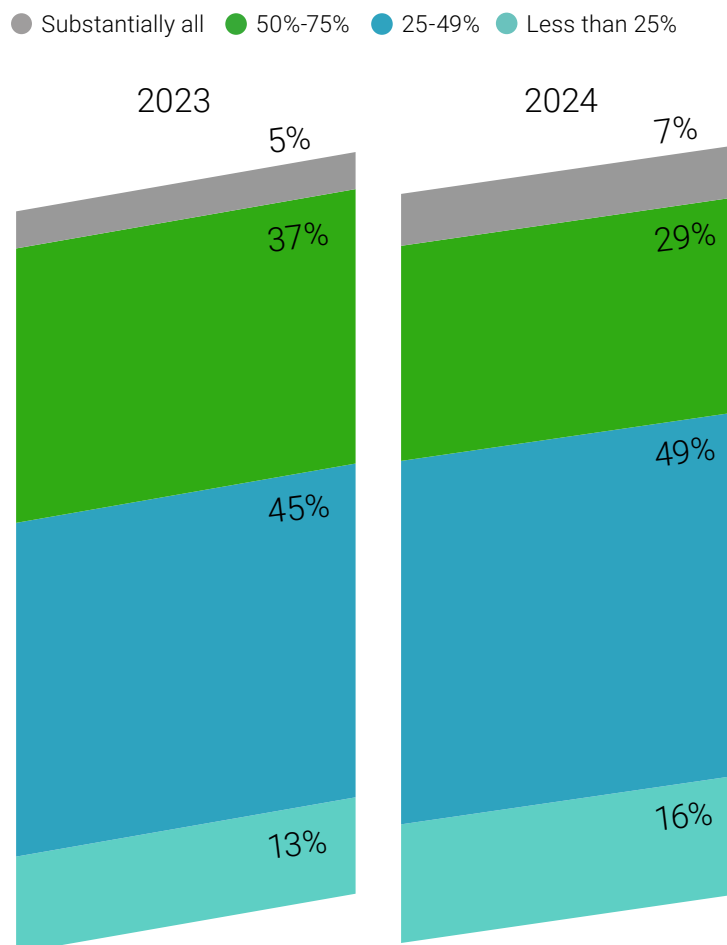
The spread of liability management from the U.S. into Europe has been a relatively slow burn. This is partly down to differences in business culture. With fewer market participants, the risk of aggravating non-participating creditors who find their grip on collateral loosened is seen as higher. That said, a number of European sponsors have U.S. style covenant packages, and it is common for the security packages in European deals to be looser, which may create more future LME opportunities.

European regimes offer other important tools, too. Schemes of Arrangement and the Restructuring Plan, the latter of which came into force in June 2020 in the U.K., are effective means of achieving "cram down" of dissenting creditors, thus displaying some similarities to the U.S. Chapter 11 regime. Insolvency options continue to exist across Europe providing business with a range of tools to manage debts. The impact and process will, of course, differ from jurisdiction to jurisdiction.

As our survey results indicate, liability management is expected to remain a factor on both sides of the Atlantic for the foreseeable future. In an era in which both interest rates and the availability of private credit remain relatively high, it is hardly surprising to see companies grasping at opportunities to stave off liquidity crunches, should they be facing them. And for private equity sponsors for whom a company in bankruptcy is a reputational risk, the ability to keep matters out of court is an important feature.

That being said, those existing lenders excluded from participating in these transactions often take the position that the credit agreements don't permit such activity. This may lead to a significant amount of litigation, which companies and their capital partners need to be well attuned to and advised on, as many of these liability management tools have not been fully tested by the courts.

What percentage of distressed companies that extended their liquidity runway through "amend & extend" approaches or by raising additional capital in 2023 and into 2024 will end up distressed again in the next 3 months?



Embedding liability management in the business plan

Liability management responds to a liquidity crisis but does not solve the underlying issues creating the unanticipated situation.

It is therefore tempting to view these as separate processes. That would be misguided.

Successful execution of a new debt offering buys time to address underlying performance issues. And a truly successful liability management exercise cannot be conducted in isolation from an operational transformation, but rather must be embedded in a credible business plan that identifies what the future looks like and the precise role that fresh capital can play in enhancing the business and enterprise value.

Put another way, the goal of liability management is to ensure with some confidence that a transaction is a means to an end as opposed to a road to nowhere. We are only beginning to see in the U.S. the fallout from failed LMEs. As these situations play out, it is becoming more important that LMEs are grounded in a credible plan that likely

leads to resolution of the company's current challenges.

This is especially true due to the often-demanding nature of the exercise. Liability management is typically a complex legal process commanding significant senior management time and attention. Properly integrating this effort within the overall turnaround strategy reduces the risk of leadership losing focus on the business plan and operating model.

Relatedly, liability management transactions can have implications for the substantive running of the day-to-day business. Asset sales or asset segregation through drop-down can trigger operational changes, creating the need for a wider assessment of people, contracts, intercompany obligations, and intellectual property usage. Without careful planning, a company that divests or spins out assets can find itself at cross purposes – particularly in more

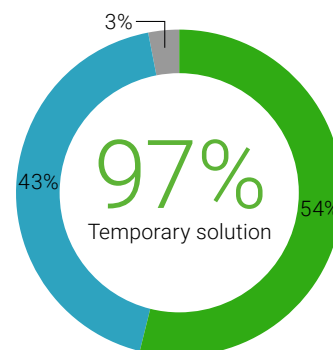
service-oriented, people-focused businesses with the transaction itself hindering operational performance.

Burnt bridges are a further consideration. By its nature, and despite the cyclical rotation of personnel in the capital markets and incentive structures within funds and banks, a liability management exercise involves elevating levels of security – and added control – for some lenders and not others. The alienation of non-participating creditors could reduce future flexibility to raise capital, meaning that the company is more reliant on the creditors and sponsor with whom it has concluded the deal. If the new money proves insufficient to kick-start the turnaround, securing further funding may prove more difficult. This makes it essential for capital requirements to be accurately sized from the outset.



In your experience, how successful have amend & extends or liability management efforts been in the past 12 months?

- A temporary solution that doesn't ultimately resolve the fundamental issues
- A temporary solution granting time to turnaround or improve operations
- A permanent fix that enables the company to rebuild enterprise value



The right advice, at the right time

In our experience, successful liability management is multidisciplinary.

Liability management is often spearheaded by the investment bank tasked with financing, valuation, and divestiture strategies. An external law firm leads the legal tactics, implementation strategy, litigation risk assessment and mitigation strategies, and often stakeholder negotiations. Turnaround advisers work with management to devise a credible transformation plan, global liquidity forecasting, business planning, and support operationalizing the transformation. And communication professionals assist as needed with how the transaction will be perceived in the marketplace.

The task for turnaround professionals is to advise management and the board on the viability of the underlying turnaround plan that a liability management transaction is intended to facilitate. This advice is an important part of establishing a sound record for boards of directors to approve implementing the liability management efforts. In addition, professionals help to bridge information and trust gaps among constituents; their “repeat player” status, independent judgment, and long-term dependence on reputation become key.

Other financial professional tasks include ensuring that the company has a clear plan for putting new borrowings to work:



Checking that a sufficient portion has been allocated to support necessary capital expenditures or investments to drive revenue growth



Scenario planning to risk assess whether the new debt will prove sufficient in the event of a market downturn



Revisiting the company's cost base to ensure it remains fit for purpose



“Grounding liability management in the context of a turnaround plan provides boards with enhanced protection in the event of a bankruptcy down the road.”

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Grounding liability management in the context of a turnaround plan provides boards with enhanced protection in the event of a bankruptcy down the road. Proper assessment of how the transaction contributes to a recovery strategy helps to create a record of appropriate decision-making at the board level.

Considerations for lenders: positioning to participate

For the creditors we advise, a running theme is ensuring that liability management doesn't happen around you, but runs through you. Lenders need to consider where they sit in the stack, the relative size of their position, and the propensity of fellow creditors to engage in "lender-on-lender violence" – all of which will bear on whether an exercise is likely and who might be invited to participate. The relationship with sponsors, who often push for liability management measures as a substitute for restructuring, can be a critical factor in determining whether or not a lender ends up inside the tent.

Where liability management is likely, lenders may need to deploy countermeasures if necessary to ensure transactions are not done around them. Over 40% of our survey respondents expect to see further creditor co-operation agreements activated in the coming year. Lenders who pledge themselves to present a common front in the face of liability management efforts create a greater likelihood of maintaining a seat at the table. But enforceability of creditor co-operation agreements remains open to question in European jurisdictions, making contingency planning for non-participation scenarios all the more important.

More than 40% of our survey respondents expected to see creditor co-operation agreements activated in the coming year.

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The relationship with sponsors, who often push for liability management measures as a substitute for restructuring, can be a critical factor in determining whether or not a lender ends up inside the tent.

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Six questions when considering liability management



While there will be differences of emphasis among the different stakeholders, certain objectives and end-result goals are common to all stakeholders: ensuring a company emerges with a healthy balance sheet, growth in enterprise value, overall alignment on a plan to deliver improved performance and sufficient liquidity to deliver on that plan.

Both companies and lenders considering liability management proposals should therefore ask themselves broadly whether the road they are being asked to travel leads to the correct destination. In particular:

1. Is there sufficient near-term liquidity to fund the completion of the transaction? Do lenders involved fully appreciate the (often constrained) timeline? This requires a careful and comprehensive analysis of a company's liquidity profile and runway, including working capital needs, debt service obligations, and liquidity levers that can be pulled.
2. Does the exercise likely provide the necessary runway to execute a turnaround plan without further recourse to the market? Sensitivities should be run to stress test assumptions and the potential operational improvements needed to validate that the funding secured should be reasonably sufficient for the organization's ongoing needs.
3. Is the underlying turnaround and business plan credible? Is the path from point A to point B passable? Advice to the board from turnaround advisors is an essential input to the board ratification process.
4. Have the implications of the transaction on the business and, subsequently, the ability to operate and achieve the turnaround been fully assessed? For example, complex transactions involving a drop-down or carve-out may have implications for vendor contracts that bar transactions between affiliated entities, requiring renegotiation of agreements.
5. Has the litigation risks been fully vetted and discussed with relevant parties? Is the potential for lender-on-lender violence likely and, if it were to occur, is the antagonism going to negatively impact the business? If so, the company is going to need a robust and credible turnaround story to reassure and retain the support of the key operating stakeholders.
6. If the LME fails and a subsequent formal restructuring occurs, has a good record been established that the transaction was a reasonable course of action to take? Establishing a solid record that drives the decision to implement an LME is essential to protect the potential downside of the transaction not working and being subsequently investigated as part of a formal insolvency proceeding.



Sticking to the fundamentals amid uncertainty

The longer-term outlook for liability management techniques remains uncertain.

Much depends on the development of case law in the U.S. and the outcome of high-profile transactions in the EU. Even without a major adverse event, liability management is a finite resource: lenders who feel they have been burned once will demand protection against such transactions in future deals. We expect the market to move to more robustly protective documentation that will reduce the scope for liability management available in individual cases, albeit slowly over time.

In the meantime, considerable scope remains for liability management transactions – particularly given the deep pools of private credit on the market. Funds remain under pressure to deploy capital without necessarily including the debt covenants that a traditional bank might require. And, in this environment, boards are in a position to delever balance sheets and reduce downside risks through liability management transactions – provided they are grounded in the fundamentals of company turnaround.

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About us

AlixPartners offers a holistic suite of integrated Liability Management Exercise (LME) services.

Liability management transactions require a path to operationalize and an understanding of the long-term implications to the operations and cash flows of the business. Our team of restructuring experts is called in by companies, investors, creditors, law firms and governments

to solve complex problems and preserve value in urgent situations. We have a track record and reputation as a world-class firm that brings the experience and expertise to lead stakeholders through these complex, time pressured scenarios and drive a business to a successful outcome in any circumstance.

For more information, please contact the authors.

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Liability Management



Faculty

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across industries. He has worked with clients through roughly 50 complex chapter 11 cases and out-of-court restructurings, and routinely develops, negotiates and challenges comprehensive restructuring transactions. Most recently, Mr. Winning was a partner at AlixPartners, and prior to that he was special counsel at Cooley LLP. He leverages his experience as both an attorney and a financial advisor. Mr. Winning's notable engagements include advising official committees in the chapter 11 cases of GWG Holdings, Chesapeake Energy, Boy Scouts of America, 24 Hour Fitness, Century 21 Department Stores, Claire's, Republic Metals, Orchard Brands, Radioshack, Mervyn's, Fusion Connect, Brookstone, Atari, Midway Gold, Marsh Supermarkets, KIT digital, Violin Memory, Pacific Sunwear, Blockbuster, Frederick's of Hollywood, Deb Shops, Vertis Holdings and Celadon Trucking. In 2018, he was selected by the American Bar Association for its "Top 40 Young Lawyers" award. He also is chair of the Governance and Audit committees of the Board of Commonpoint Queens, a nonprofit social services organization that reaches more than 50,000 members of its community each year. Mr. Winning received his undergraduate degree *summa cum laude* from Washington University in St. Louis and his J.D. from Columbia University School of Law, where he was a James Kent Scholar.