D&G | Davis & Gilbert LLP
ATTORNEYS AT LAW

FEBRUARY 3, 2009

INSOLVENCY & BANKRUPTCY
>> ALERT

DEALING WITH ADVERTISERS & VENDORS IN BANKRUPTCY

A GUIDE FOR THE ADVERTISING AGENCY

Politicians spend considerable time talking about the troubles on Wall Street affecting the pocketbooks of those on Main Street, but they neglect to mention there is another street that is a significant bellwether of the economy, Madison Avenue. That's where slashed marketing budgets, bankruptcies of once large advertisers and the implosion of online-ad networks are putting the squeeze on the advertising industry.

The only thing more alarming than all the bad news is the speed at which bad things happen to good relationships, sometimes without any warning. If you find yourself suddenly dealing with the bankruptcy of a client or vendor, there are three basic principles of the Bankruptcy Code that will affect you in several important ways, including the actions you may take and your amount at risk. We explain each of them briefly below and provide some tips to guide you. Of course, if possible, it would be better to avoid being subject to the bankruptcy process entirely, so now is the time to review your contracts, and consider including in any new contracts provisions that will better protect you in the event of your client's or vendor's insolvency.

AUTOMATIC STAY

The commencement of a bankruptcy proceeding generally begins with the filing of a petition for relief by the debtor under Chapter 7 or Chapter 11 of the Bankruptcy Code. A Chapter 7 proceeding is a liquidation. The debtor essentially stops operations and turns over the keys to the company to a trustee, who proceeds to collect any assets and make distributions to creditors according to the priorities set forth in the Bankruptcy Code. In contrast, a Chapter 11 proceeding is generally intended by the debtor to be a reorganization (or sometimes an orderly liquidation) and the debtor's management is usually permitted to remain in possession of the debtor's business and assets absent fraud or incompetence. Because the debtor continues to operate its business under Chapter 11 post filing of the bankruptcy petition, the bankruptcy court administering the debtor's case is frequently required to balance the

>> continues on next page

THE BOTTOM LINE

Every crisis presents an opportunity, and the current financial crisis is no exception. Now is a good time for the agency, together with its legal advisors, to take the following actions:

>> Review forms of insertion orders and other documents submitted to media to ensure the agency is not taking unnecessary risks in light of its agreements with clients, current case law and trends in the advertising industry.

>> Review the agency's course of conduct with its clients and media for consistency with agency's expressed status in insertion orders and client contracts (e.g., as agent for disclosed principal or under sequential liability).

>> Review forms of client-agency agreements and other contracts and consider including provisions that would give the agency more flexibility to terminate the contract or change terms in the event certain early warning triggers are tripped. For example, the agency may consider inserting a provision that allows it to modify payment terms if a client's financial condition deteriorates or permits it to

>> continues on next page

THE BOTTOM LINE

>> continued

terminate a contract in the event a vendor or client fails to achieve or maintain certain financial covenants.

- Where possible, the agency may minimize the risk of a preference action by requiring advance payment from any client in financial distress (advance payments fall outside the definition of a preference and are less vulnerable to attack).
- Formalize agreements with vendors and subcontractors, including buying companies and ad networks to clearly delineate/limit any authority of such entities to legally bind the agency to other third parties.

rights of the debtor against the rights of its creditors according to the checks and balances contained in the Code, often through the use of its own equitable discretion. Ultimately, the bankruptcy court works toward the equitable distribution of assets among the debtor's creditors.

The first step toward such equitable distribution and the basic foundation of bankruptcy relief is an automatic freeze on virtually all creditor activity. This is known as the "automatic stay" and it is highly valued by both debtors and bankruptcy judges. An automatic stay is imposed immediately upon the filing of a bankruptcy petition, which has the effect of a court order, stopping actions by creditors to collect on debts outstanding as of the petition date. This is intended to provide the debtor with breathing room to effect a reorganization. The implication for the advertising agency as creditor is that it must stop all collection activities against an advertiser/debtor in bankruptcy as of the petition date. If it does not, and is found to have violated the automatic stay, it may be held in contempt of court.

Practically then, the advertising agency should not only cease all collection efforts for services rendered prior to the petition date, but also be careful not to take any actions that may have an impact on receivables related to pre-petition activity. For example, the agency should not seek to exercise rights of setoff under contract or otherwise, without consulting an attorney regarding the appropriateness of the action and compliance with law.

EXECUTORY CONTRACTS

Going forward, the advertising agency must be careful before making any decision to terminate its contract with the debtor. A potent protection for the debtor and core policy of the Code is that debtors should generally be allowed in their discretion to continue or terminate certain contracts that existed on the petition date. Such contracts are known as "executory contracts", and although that term is not defined in the Code, it is basically understood to mean a contract where substantial actions are yet to be performed by both parties as of the petition date. The debtor may elect to "assume" (i.e., accept) or "reject" (i.e., terminate) any executory contract at any time prior to court approval of its plan to exit bankruptcy, which may be years down the road.

Where the underlying contract requires the agency to extend credit or make media commitments on behalf of a debtor/advertiser or pay amounts over to a debtor/intermediary, it is reasonable for the agency to want to terminate the underlying contract in

>> continues on next page

order to reduce its risk. In such cases, it should first consult with an attorney to determine whether the contract may be an executory contract under the Code. The agency should not assume, without such consultation, that it may exercise termination provisions contained in the underlying contract based solely upon a bankruptcy filing.

As a counterbalance to the debtor's right to assume or reject executory contracts, bankruptcy law provides some protection to creditors for doing business with a debtor during the bankruptcy proceedings. There may be an opportunity for the agency as creditor to compel the debtor to provide assurance of payment or performance where the agency is at substantial risk or exposure to media. Also, as a reward for providing services to the debtor during the bankruptcy, the agency's claim for such services should be entitled to an administrative expense status, which provides priority over general, unsecured creditors. This administrative expense priority treatment for post-petition services makes it comparatively less risky to do business with a debtor in bankruptcy versus an entity on the verge of bankruptcy. It is not a guaranty of payment, however, because the debtor may wind up in liquidation unable to pay its administrative expenses.

PREFERENTIAL TRANSFERS

Even where the agency is continuing a good business relationship with the advertiser/debtor in bankruptcy, it may still find itself subject to a preferential transfer or "preference" action by the debtor or trustee. Generally speaking, in the advertising context, a preference is simply a payment made by the debtor in the 90 days prior to bankruptcy on account of an antecedent (i.e., existing) debt that enables the agency to obtain more than it would have in a Chapter 7 liquidation of the debtor. The debtor is presumed to be insolvent in the 90 days prior to the petition date. Preference liability is strict liability, so the agency's intent in accepting the payment is irrelevant.

Ad agencies are in a uniquely dangerous position as the "initial transferee" of potential preference payments. The entire amount received from a debtor, ***including funds the agency paid over to media,*** may be subject to a preference attack.

There are just a few defenses available to the agency, each with a specific set of challenges. The "ordinary course of business" defense is the most common defense but it is very fact specific and requires a detailed analysis of the timing and manner of payments by the debtor to the agency from the beginning of the relationship. A defense known as "new value" may be available where the agency continued providing valuable services to the debtor after the alleged preference. Significantly, the agency may, in certain circumstances, be able to defend a preference claim involving media payments as a conduit to media for media receivables. In each case, however, legal analysis is needed to assess the agency's exposure and resolve any preference attack. The vast majority of preference actions are capable of being resolved through settlement, rather than litigation.

FOR MORE INFORMATION

Joseph Cioffi, Partner
212.468.4875
jcioffi@dglaw.com
or the D&G attorney with whom you have regular contact.

DAVIS & GILBERT LLP
T: 212.468.4800
1740 Broadway, New York, NY 10019
www.dglaw.com