

Retail and Consumer Products Advisory: Selling and Honoring Gift Cards in Bankruptcy

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These trying economic times have had an impact on almost every facet of consumer behavior, including gift card sales. The gift card market is significant: just one year ago, some sources estimated that gift card sales could grow to reach \$100 billion in 2008 as compared with \$80 billion in 2006.¹ But actual spending on gift cards has fallen dramatically: a November estimate lowered projected gift card sales in 2008 to around \$60 billion.²

Consumers may fear that gift cards will not be honored if the retailer in question files for bankruptcy or faces other financial challenges. Directors and officers of retail companies may worry about liability if the entity is not able to honor the cards it sells. These concerns highlight the need for retailers to understand the mechanics of selling and honoring gift cards in a difficult economy.

Can Retailers Honor Gift Cards During Bankruptcy?

As a general rule, when a company files for bankruptcy it is barred from paying any obligations that arose before filing—including gift cards.³ Accordingly, retailers should not honor gift cards before seeking leave of the court.

A retailer's decision to seek permission to honor gift cards will depend on the context of the bankruptcy.⁴ Retailers pursuing reorganization under Chapter 11 of the Bankruptcy Code will likely seek permission to honor gift cards in an effort to preserve customer loyalty, which would be an important component of a retailer's viability under a successful reorganization. In bankruptcies that will end up in liquidation, retailers are less likely to seek—and creditors are less likely to go along with—leave to honor gift cards.

Retailers seeking court permission to honor gift cards will typically move for such permission during the “first day motions” (requests that occur at the outset of the bankruptcy proceedings). Generally, the motion will request an order authorizing—but not directing—the retailer to honor gift cards issued before the bankruptcy petition was filed. If the court grants this order, the retailer will still have the discretion to decide whether or not to honor gift cards.

Frequently, retailers in bankruptcy will seek to limit the time during which gift card holders may redeem their gift cards to, say, 30 or 45 days after the order is entered. They may also require the holders to make additional purchases in amounts in excess of the face amount of the gift card, or they may require the gift card to be fully redeemed (in other words, no “change” would be returned if the sale is for less than the gift card's face value).

What Happens If a Retailer Does Not Honor Gift Cards During Bankruptcy?

If a retailer does not honor gift cards, gift card holders have to stand in line with the other creditors in the case. The first debts paid are those of secured creditors, who have a lien on certain assets of the debtor. Debts to priority status creditors are paid next. Administrative expenses for the bankruptcy proceedings, contributions to employee benefit plans, and certain kinds of taxes are just a few examples of priority debts. Debts to general (non-priority) unsecured creditors are paid only after all priority creditors have been satisfied in full. These creditors split up whatever money remain, if any.

Holders of gift cards are either priority status creditors or unsecured creditors. One of the Bankruptcy Code priority provisions affords priority status to “deposits” of money made before the commencement of the case in connection with the purchase of property (up to \$2,425).⁵ Courts have disagreed as to whether gift cards (or certificates) constitute a deposit,⁶ so it is not clear to which group gift card holders belong.

In either event, there is a very good chance that gift card holders will not see all or any of their money if retailers do not honor gift cards in bankruptcy. If this becomes widespread practice, consumer fears could subject even healthy retailers to further declines in gift card sales.

Are Officers and Directors of an Insolvent Retailer Liable for Their Company's Failure to Honor Gift Cards?

Directors and officers of retail companies should be concerned if the company sells gift cards while insolvent. An entity is generally considered insolvent when it is unable to pay debts as they come due or when its liabilities exceed its assets.⁷ Purchasers of gift cards might attempt to make a case for individual liability on fraud and consumer protection theories.

A successful fraud claim would typically require that consumers prove that directors and officers sold cards with the intent to deceive customers. It would be hard for a consumer to prevail on a fraud claim, because directors and officers would likely argue that they had no intent to deceive because they did not know the cards would not be honored.

A consumer protection claim would not necessarily afford relief against directors and officers, because consumer protection laws typically provide remedies against companies and not against individuals. Consumers would face the same difficulties as with fraud claims, because consumer protection laws also generally protect against fraudulent or deceptive practices. However, in the case of a retailer selling gift cards when officers and directors know that the cards will not be honored, the result could differ.

Endnotes

¹ “Avoid Gift Card Pitfalls,” *Consumer Reports* (last visited Dec. 8, 2008); see also Gonzalo Mon, “Navigating Gift Card Regulations,” *Manage Smarter* (last visited Dec. 8, 2008).

² See Alina Tugend, “The Gift Card Comes Wrapped in Growing Risk,” *N.Y. Times* (November 22, 2008).

³ There is some speculation that gift certificate holders might not be considered bankruptcy creditors in states where gift certificates are statutorily defined as “value held in trust by the issuer.” See, e.g., Cal. Civ. Code § 1749.6 (2008) (California statute creating statutory trust and directing gift certificate issuers to honor them even if bankruptcy has been filed). Some commentary suggests that these statutes might be invalid as preempted by the Bankruptcy Code's priority scheme. Dan Schechter, Commercial Finance Newsletter, “Gift Certificate Holders Are Entitled to Sixth Priority Treatment,” 2004 Comm. Fin. News 64, Sept. 13, 2004; see 11 U.S.C. § 507 (2008) (bankruptcy priority scheme).

⁴ See, e.g., Debtors' Motion for Order ... Authorizing Continuation of Certain Customer Practices, Circuit City Chapter 11 Proceedings, No. 08-35653-KRH (Bankr. E.D. Va. 2008).

⁵ 11 U.S.C. § 507(7) (2008).

⁶ Compare *in re WW Warehouse, Inc.*, No. 03-13655 JBR., 313 B.R. 588, 2004 WL 1895113 (Bankr. D. Del. 2004) (finding that money paid for gift certificates constituted “deposits” within the meaning of the Bankruptcy Code) with *Nw. Financial Express, Inc. v. JWD, Inc.*, 950 F.2d 561 (8th Cir. 1991) (finding that the term “deposits” refers only to partial payments of future purchases, while gift certificates are prepayments in full not within the meaning of the Bankruptcy Code provision).

⁷ The first definition (being unable to pay debts as they come due) is referred to as “equity” insolvency and the second definition (having liabilities that exceed assets) is referred to as “balance-sheet” insolvency. See Black's Law Dictionary 811 (8th ed. 2004).

For assistance in this area, please contact one of the attorneys listed below or any member of your Mintz Levin client service team.

Faith L. Charles
(212) 692-6770
FLCharles@mintz.com

Stuart Hirshfield
(212) 692-6771
SHirshfield@mintz.com

Cynthia J. Larose
(617) 348-1732
CJLarose@mintz.com

Richard E. Mikels
(617) 348-1691
REMikels@mintz.com

Tavis J. Morello
(617) 348-4464
TJMorello@Mintz.com

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