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Gift Card Value when Issuers Go Bankrupt

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The Sharper Image. Linens-N-Things. Lillian Vernon. These are but a sample of big-name retailers that filed for Chapter 11 bankruptcy in 2008.[1] Businesses are understandably worried about the increasing number of bankruptcies. And now that consumers are putting more and more value on gift cards, they may need to be worried, too. According to research firm Tower Group, estimated gift card sales totaled $97 billion in 2007, well above sales of $83 billion in 2006.[2] But few card purchasers have any idea what might happen to a card if the company that sold it were to file for bankruptcy later.

When consumers buy gift cards from a retailer, it's a form of savings. They are paying up-front for future purchases at that company, either for themselves or for someone to whom they are giving a gift. But in today's economy, bankruptcy often strikes unexpectedly at retailers that seem to be doing well. Larger companies frequently harbor millions of dollars in outstanding gift card value, and the law allows them to use that value for paying off creditors instead of honoring consumers' cards. For families that use gifts cards as a budgeting mechanism, a retailer's bankruptcy can have serious consequences.

Gift Cards and Retailer Bankruptcy

When a retailer files for Chapter 11 bankruptcy (which unlike Chapter 7 allows the company to continue operations while reorganizing its debt), it must submit a plan of reorganization explaining how it proposes to pay back its creditors. It actually has to petition the court if it wishes to honor customer service programs such as gift cards. Under the circumstances, three scenarios are possible.

First, a retailer may simultaneously file for bankruptcy and petition to honor gift cards. That was the approach adopted by Kmart in 2002, and it allowed operations to go on without a hitch.

Second, a retailer may file for bankruptcy and later, after bankruptcy proceedings have begun, petition the court to allow it to accept gift cards. The unknown period of time between the filing and the petition can leave the gift-card holder in limbo. Because the purpose of a Chapter 11 filing is to keep a business afloat and retain customers, retailers who want to keep customers happy are likely to seek permission to accept gift cards. The only question is when the customer will be able to access the value.

Gift Cards and Expiration Laws

New England State	Expiration Period for Cards Issued by a Retailer
Connecticut	Expiration dates prohibited
Maine	Expiration dates prohibited
Massachusetts	Seven Years
New Hampshire	Expiration date prohibited for cards valued at less than $100
Rhode Island	Expiration dates prohibited
Vermont	Three years

For information on state gift card statues see http://www.ncsl.org/programs/banking/GiftCardsandCerts.htm

When Sharper Image filed for bankruptcy on February 19, 2008, customers complained that they were unable to use their gift cards. As a result, Sharper Image requested and received permission for a modified acceptance program. If customers would spend twice the amount available on a gift card in a single transaction, they could redeem it. Rival Brookstone, seeing a business opportunity, offered a 25 percent discount on its own merchandise in exchange for Sharper Image gift cards.

Third, a retailer may decide not to seek permission from the bankruptcy court to honor gift cards. In this case, gift cards for that retailer are rendered valueless unless the cardholder files a proof of claim, a cumbersome process.

Any situation in which consumers experience a temporary or permanent loss of the cash value placed on cards could create problems for both individuals and families.

What Can the Consumer Do?

In anticipation of any future bankruptcy, a gift card should be treated as cash and used sooner rather than later. Also, consumers should be mindful of applicable state laws, which vary with respect to expiration dates, dormancy fees, and disclosure requirements. (See "Gift Cards and Expiration Laws.") Consumers should note the terms of the gift cards and be clear as to when the card can be used. Is there an expiration date? Is a fee charged if the card is not used for a certain amount of time? What happens if the holder loses the gift card? In any case, state laws protect gift-card holders from disadvantageous terms only during a retailer's normal course of business and do not address bankruptcy. The bottom line is that the cards should be spent rather than saved—there is always a chance that the retailer could declare bankruptcy.

If a retailer in bankruptcy does not accept gift cards, consumers have two options. First, they can turn to rival retail companies that offer promotions tied to the bankrupt retailer's gift card. Brookstone's successful promotion involving the Sharper Image card may inspire other retailers to have similar promotions when bankrupt competitors place restrictions on cards or refuse to honor them at all.

Second, a consumer can file a claim as a creditor against the bankruptcy estate. Bankruptcy law provides gift-card holders with some level of priority among unsecured creditors.[3] The secured creditors (creditors who lent money to the company to buy assets) are paid first. After that, unsecured creditors are paid in a specified order. Such proceedings take time, and gratification does not occur instantly, if at all, given that payment depends on the amount of assets left over after secured obligations are met. It is a rare unsecured creditor that is lucky enough to be fully compensated. The typical unsecured creditor will receive partial payment or nothing.

The Future of Gift Cards

Current trends indicate that consumers are increasingly purchasing branded prepaid gift cards, such as those offered by American Express, Visa, MasterCard and other credit card companies.[4] The cards offer versatility and a sense of security because they allow consumers to recover funds for lost or stolen cards and to shop anywhere the card logo is accepted. However, much like retailer gift cards, the branded cards do not guarantee against bank failure. Furthermore, they often include service fees.

People holding gift cards of any kind should be mindful of applicable laws as well as the terms and conditions for each individual gift card. No one wants to be among those consumers who lose nearly $8 billion annually—approximately 10 percent of gift card sales—as a result of unredeemed value, expiration, or loss of cards.[5] The best advice for retaining card value and avoiding the consequences of company bankruptcy is to use gift cards in a timely fashion rather than save them for a rainy day.

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Endnotes

[1] From 19,695 in 2006 to 28,322 in 2007. See American Bankruptcy Institute, "Annual Business and Non-Business Filings by Year (1980–2007)," http://www.abiworld.org.

[2] Dan Mitchell, "Fruitcake Might Be a Better Gift," *The New York Times*, January 5, 2008.

[3] See 11 United States Code Annotated § 507.

[4] See *Survey of 8,000 Consumers Shows Branded Gift Cards are the Preferred Gift Among Family and Friends* (Montvale, New Jersey: Network Branded Prepaid Card Association, May 15, 2008), http://www.nbpca.com/docs/NBGC-Recipients-Behaviors-PR.pdf.

[5] Tower Group, "With Soaring Gift Card Sales Poised to Exceed $80 Billion in 2006, Unused Card Values Are Also on the Rise," November 20, 2006, http://www.towergroup.com/research/news/news.htm?newsId=1740.