BANKRUPTCY LAW BULLETIN

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THANKS... FOR NOTHING?

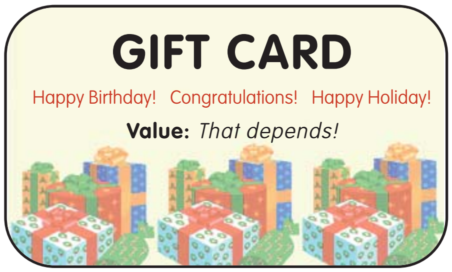
GIFT CARDS MAY BECOME WORTHLESS IF THE RETAILER GOES BANKRUPT

By Stuart Gordon and Matthew Spero

With the proliferation of Internet purchasing in the 21st century, gift cards (essentially a gift certificate that looks like a credit card and entitles its holder to some finite amount of credit at a retail or other store) have become ubiquitous. Almost daily, we hear of another retailer filing for Chapter 11 bankruptcy protection. With household names like Fortunoff's, Lillian Vernon, and Red Envelope joining the ranks, many gift card holders are finding themselves at the mercy of the retail debtor's generosity.

Over 100 million people received gift cards this holiday season. Millions of others returned duplicate gifts or sweaters that did not quite fit and chose to receive a gift card or store credit in exchange, rather than take the time to select a replacement item. Several of us also took those gift cards and put them in a drawer and forgot about them. Those holders of The Sharper Image gift cards who were dilatory in redeeming them recently discovered that their gift cards were essentially worthless after The Sharper Image announced, for a time, that it would not honor them.

Gift card holders were, unsurprisingly, outraged. The Sharper Image had been in business for over thirty years and it seemingly had a store in every mall in America. Nonetheless, on February 19, 2008, a mere two months after the company sold countless gift cards during the 2007 holiday season, The Sharper Image's gift cards were not worth the price of the proverbial plastic they were printed on. While many holders took to Internet message boards and demanded an investigation by the Attorney General, under the Bankruptcy Code the company was allowed to treat gift card holders as nothing more than unsecured creditors with a claim against its bankruptcy estate.



Bankruptcy Code section 507(a)(7) states that individuals who "deposit" money with a debtor prior to the bankruptcy filing in connection with (among other things) the purchase of property, are entitled to a "seventh priority" unsecured claim (capped at $2,425). This means that, generally, such individual must "get in line" behind those who are owed debts that: a) arise during the debtor's bankruptcy; b) are secured by an interest in the debtor's property; or c) relate to wages, salaries, or commissions of the debtor's employees or contributions to employee benefit plans. In the event the debtor is attempting to reorganize, remain in business as a going concern, and ultimately emerge from bankruptcy, it will be in that debtor's best interest to apply to the Bankruptcy Court for authorization to honor its outstanding gift cards, notwithstanding section 507(a)(7). Since retail debtors are dependent upon creating and maintaining goodwill with their customers, the failure to honor outstanding gift cards is a sure-fire way to alienate customers and turn them into ex-customers. Debtors who seek to emerge from Chapter 11 must also pay "priority" creditors, such as those holding unredeemed gift cards, the full amount of their priority claims.

However, in the increasingly common event that a retail debtor determines that it cannot survive a reorganization, it no longer has any incentive to placate its customers and it (or some other party in interest in its bankruptcy case) may decide to save the money the debtor otherwise would have had to pay to honor gift cards and utilize that money for some other purpose. If such debtor liquidates (as opposed to reorganizes), creditors are paid in order of the priority scheme set forth in the Bankruptcy Code, and it is not uncommon for seventh-priority unsecured creditors (e.g. gift card holders) to receive nothing on account of their claims.

The Sharper Image ultimately responded to its irate customers by offering to honor its gift cards - provided that the holder used the entire value of the card in a single transaction and applied it to a purchase worth twice the value of the gift card. Such conditions, incidentally, are becoming increasingly common as retailers seek to capitalize on the popularity and pervasiveness of gift cards. Holders always need to be aware of the dreaded "fine print" and terms of their gift cards.

So consider this our small attempt to spur the economy: clean out your drawers, wallet, or pocketbook and spend that gift card while it still has value. The old adage otherwise could apply: "Use it or lose it." ■

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