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Gift Card Today, Unsecured Creditor Tomorrow

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The current uncertainty of the financial markets make one thing certain: retailers are in significant trouble. If you are a consumer holding a gift card to a financially distressed retailer or restaurant, now is the time to redeem those cards before they become worthless.

Consumers spent an estimated $26.3 billion in gift cards at retailers alone during the 2007 holiday season, according to the National Retail Federation. But today's financial climate highlights the risk that consumers take by purchasing and holding gift cards from financially distressed companies.

The current economic meltdown has driven some well-known companies to file for bankruptcy, among them, Circuit City, Linens 'n Things, Levitz Furniture, Mervyn's, Gottschalks, Sharper Image, Bombay Company, BabyStyle, and kB Toys, to name a few. As retail sales continue to plummet, it is expected that many more retailers will seek bankruptcy protection in 2009.

To understand why gift card holders are at such great risk in a retail bankruptcy, a brief overview of bankruptcy is in order. When a company files for bankruptcy protection, they can either choose to file a bankruptcy petition under Chapter 7 or Chapter 11 of the Bankruptcy Code. Under Chapter 11, the debtor is seeking to reorganize its business, restructure its debt, and to emerge from bankruptcy as a more competitive and profitable company. Under Chapter 7, the debtor has determined that it cannot continue its business, and therefore, must liquidate in order to maximize value for its creditors.

The date that the bankruptcy petition is filed is significant as it defines the priority and treatment of the company's creditors. Debt incurred prior to the petition date is pre-petition debt and receives different treatment then debt incurred after the filing of the petition. In general and oversimplified terms, creditors of the bankruptcy estate receive payment in the following order: secured debt, administrative claims, unsecured priority debt, unsecured non-priority debt, and then equity interests.

Holders of pre-petition gift cards fall into unsecured nonpriority debt category. Essentially, a gift card purchaser makes an unsecured loan to the gift card issuer. That loan is "repaid" when the consumer redeems the gift card for merchandise, food or services. There are two primary reasons that the redemption of gift cards post-petition are disfavored. First, it allows a pre-petition unsecured creditor to receive "property" of the bankruptcy estate in contravention of the Bankruptcy Code's priority scheme. Second, the redemption of the gift card depletes value from the bankruptcy estate. A gift card redeemed for merchandise provides no benefit to the estate since it depletes merchandise that could have been sold for cash.

Fortunately, debtors and bankruptcy courts have realized the value in continuing the debtor's gift card program. In a Chapter 11 case, the debtor will need customer goodwill if it hopes to reorganize. Refusing to honor gift cards is a surefire way of destroying any remaining goodwill. When Sharper Image filed for bankruptcy, it indicated that it did not intend to honor its outstanding gift cards. It wasn't until after significant public outcry that the embattled retailer sought bankruptcy court approval of a modified gift card program. The court allowed the consumer to redeem the entire amount of their gift card only if they spent twice that amount on Sharper Image merchandise.

Similarly, high-end baby and maternity clothing retailer, Babystyle, obtained bankruptcy court approval allowing it to honor gift cards only at the stores that were not being liquidated. Bombay Company initially obtained approval to honor its pre-petition gift card obligations, but less than three months after commencing its bankruptcy case, the bankruptcy court permitted them to terminate all gift card redemptions.

On the other hand, Circuit City immediately sought bankruptcy court approval to continue honoring its gift card obligations, and is still accepting gift cards even as it liquidates all of its stores. KB Toys obtained authorization to honor its gift card program with the ability to terminate the program in its sole discretion. Similarly, Gottschalks obtained approval to honor its gift card obligations in an amount not to exceed $10 million.

Whether a particular retailer will honor its gift cards is a guessing game. The prospects for reorganization and the amount of unredeemed gift cards will be the main factors that dictate whether, and for how long, the retailer will continue to accept its pre-petition gift cards.

So, as the economy worsens and more retailers file for bankruptcy, what's a consumer to do?

The most obvious protection is to spend those gift cards before the retailer files for bankruptcy. Slow moving merchandise, store closings, and layoffs are clear signs that the retailer is in significant trouble. If the retailer has already filed for bankruptcy, the retailer may still accept gift cards. It usually takes a few days to a week for the bankruptcy court to enter the initial orders authorizing the debtor to either continue or terminate their gift card programs. Fortunately, the recent trend is that the courts are granting orders permitting the retailer to continue its gift card program, but with the discretion to terminate the program as necessary. Thus, the quicker a gift card holder can get into that store, the better their chances for redeeming that card for full value.

If the bankrupt retailer is no longer accepting gift cards, there may be other options available from its competitors. Brookstone offered Sharper Image's customers 25 percent off of Brookstone's merchandise in exchange for their worthless Sharper Image gift cards. Similarly, Texas Roadhouse offered Bennigan's customers a free entrée in exchange for Bennigan's gift certificates.

Another option is to file a proof of claim against the retailer's bankruptcy estate. Recall that gift cards are non-priority unsecured debt; therefore, the likelihood of any meaningful recovery is remote. The state's consumer protection agencies may also provide consumers with relief. Recently, a local spa in Missouri ceased doing business leaving 300 hundred consumers with worthless gift cards. Those consumers filed complaints with the Attorney General's office, which got the former owners of the spa to pay up to $103,000 to redeem the unused gift cards.

We can expect to see many more retail bankruptcies in the coming year. For consumers holding gift cards, the message is clear: spend them now, and buy new ones only from the most stable of retailers.

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