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New Laws Continue To Complicate Gift Card Programs

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A growing number of retailers are selling gift cards to consumers. Various reports indicate that more than $110 billion worth of gift certificates were sold in 2005, with over $18 billion of those sales occurring during the holiday season alone. And, consulting firm Bain & Company reported that over 75,000 stores had gift cards on display last holiday season – 50 times more stores than five years ago. Although the figures from 2006 aren't in yet, this trend promises to continue. In fact, according to a recent survey by BK Research, one in five consumers plan to purchase a branded gift card this season.

It's not hard to see why gift cards have become so popular with the public. Consumers like the convenience that gift cards bring to the task of buying presents for others. Many consumers even purchase gift cards for themselves in order to speed up transactions and avoid having to carry change. It's even easier to see why retailers like gift cards. Gift cards essentially allow retailers to create a proprietary currency that guarantees consumers will come back to the retailers' stores or otherwise lose the value remaining on their gift cards. In fact, evidence suggests that many consumers spend more than the initial value of their gift cards.

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Traditionally, many retailers that sell gift cards have made their cards subject to expiration dates and dormancy fees after extended periods of non-use. This strategy offers a number of benefits. For example, it can speed up the time in which a transaction can be recognized as revenue, and it helps prevent a retailer from having potential obligations that extend for an indefinite period of time. These types of restrictions used to make a lot of sense because, up until a few years ago, only a handful of states restricted expiration dates and dormancy fees. This legal landscape is rapidly changing, however. Over the past five years, a growing number of states have begun to regulate gift cards. And now, there is also the possibility of regulation on the federal level.

State Consumer Protection Statutes

Currently, almost half the states have laws that restrict expiration dates and dormancy fees on gift cards. The laws vary significantly in their scope. For example, some states – including California, Connecticut and Maine – currently prohibit any expiration dates on gift cards. Other states – including Hawaii, Kansas and Massachusetts – allow expiration dates, but they provide a minimum amount of time that the gift cards must be valid. (The longest period is dictated by Massachusetts where gift cards must be valid for at least seven years.) And, a third category of states – including Arizona, Georgia and Nebraska – simply requires that expiration dates be clearly disclosed in a specific manner.

State laws related to dormancy fees generally break down into similar groups. Some states – including Connecticut, Hawaii and Kentucky – generally prohibit companies from imposing any dormancy fees. Other states – including Maryland, Nevada and New Jersey – restrict the amount of fees that can be imposed and when they can be imposed. (For example, in New Jersey, a dormancy fee cannot be charged within the 24 months following the date of sale or within the 24 months following the most recent activity or transaction. When a fee is charged, it cannot exceed $2.00 per month.) The last category of states – including Arizona, Georgia and Maine – simply require that fees be clearly disclosed in a specific manner.

This growing patchwork of regulations is making it increasingly difficult for companies to offer gift cards on a nation-

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wide basis. Some companies may find it beneficial to create geographically targeted gift cards that are valid only in one state or a group of states that have similar laws. Thus, if a company wants to use expiration dates or dormancy fees, it can structure a gift card offer that is only valid in states where such restrictions are not prohibited. Another possibility is to do without expiration dates and dormancy fees in all states. In the face of increasingly burdensome consumer protection laws, a growing number of retailers are choosing this option. Although this leaves retailers without the benefits that they could derive from expiration dates and dormancy fees, it is a lot easier to manage as the legal landscape keeps changing.

The Possibility Of Federal Regulation

Despite the increase in these types of state laws, federal regulators are questioning whether additional laws are needed. In December 2005, for example, Representatives Charles Bass (R – NH) and Joe Barton (R – TX) sent a letter to FTC Commissioner Deborah Platt Majoras requesting that the FTC look into how gift cards are marketed, sold and used. In February 2006, Commissioner Majoras responded that although there may be valid reasons for expiration dates or fees, "consumers are entitled to know all material terms." These terms should be clearly disclosed to consumers prior to purchase. After receiving the response from Commissioner Majoras, Representative Bass said that he would request a hearing to determine if there should be uniform guidelines for all issuers. It's possible that this request spurred the FTC to take some action because, based on a recent SEC filing, we now know that shortly after the Commissioner sent her letter to Congress, the FTC began to investigate how a major restaurant company markets its gift cards.

In its 2006 annual report, Darden Restaurants, Inc. – the company that operates such restaurants as the Olive Garden and Red Lobster – announced that the FTC is investigating the company's marketing practices and alleging that Darden violated Section 5 of the FTC Act by failing to provide adequate notice that its gift cards are subject to dormancy fees if not used for 24 consecutive months. The proposed consent order included, among other things, requirements that Darden provide over $31 million in monetary relief, suspend the collection of dormancy fees on previously issued gift cards, and make certain disclosures relating to dormancy fees. The parties will almost certainly settle on less onerous terms, but the opening suggestions illustrate the consequences of failing to adequately disclose gift card terms.

Bank-Issued Cards Are Exempt From State Laws

It is too early to see whether the FTC's action will be enough to satisfy Congress, but some lawmakers have hinted that federal legislation may be in order. Even if Congress is successful in having the FTC regulate gift cards, however, the FTC's authority may not extend to all types of gift cards. In addition to the typical gift cards issued by merchants, a growing number of banks have started to issue their own cards. On August 1, 2006, a federal judge ruled that New Hampshire could not impose state gift card laws governing dormancy fees on bank-issued gift cards sold by Simon Property Group. Because these gift cards were issued by banks, they were governed by federal banking laws. The court ruled that these laws supersede the state laws and, therefore, that Simon did not have to comply with state restrictions on dormancy fees.

In an effort to bring some uniformity to how banks disclose gift card terms, the Office of the Comptroller of the Currency issued guidelines for banks on August 14, 2006. These guidelines encourage banks to disclose expiration dates, dormancy fees and instructions on how consumers can get more information. Each of these disclosures should appear on the cards themselves, or on a sticker affixed to the cards. The Comptroller also noted that gift cards pose special challenges because the person who will use a gift card is generally not the same person who purchases the card. To ensure that the gift card recipients have access to important information about the cards, the Comptroller encouraged issuers to include the relevant details in the promotional packaging or other location that will be passed on to the recipient.

Escheat Laws Add Additional Complications

Complying with the laws noted above is a complicated task, but a retailer's job doesn't end there. Apart from consumer protection statutes governing gift cards, it is important to note that many state statutes governing abandoned property provide that unredeemed gift cards will escheat to the state after a specified period of time. If a gift card is subject to escheat, a retailer must then turn over the "abandoned" funds to the relevant state after a period of time.

Finding out which state's escheat laws do (or do not) apply can be tricky. At the risk of oversimplifying a complicated issue, the "first priority rule" holds that if a gift card issuer knows where the holder of a gift card lives, the laws in the holder's state of residence will apply. And, the "second priority rule" holds that if the issuer knows where the holder lives, the laws in the issuer's state of incorporation will apply. So, if a retailer that is incorporated in Virginia knows that the holder of a gift card lives in Maryland, it must look to the escheat laws in Maryland. If the retailer doesn't know where the holder lives, it will look to Virginia law.

Many companies do not know where the holder resides – which is typical since the purchaser and the holder are usually not the same person – and, therefore, incorporate in a state where gift cards are not subject to escheat. That strategy can be complicated, however, by some states which subscribe to a "third priority rule." This rule generally holds that if gift cards aren't subject to escheat in the state of incorporation, the laws in the state of sale should apply. There is some controversy among issuers about how to handle the third priority rule and about whether it is even constitutional.

Remain Vigilant

Despite all of the legal hurdles, gift cards can still offer significant benefits for retailers. But, in the long term, retailers will only be able to reap these benefits if they spend the time to lay the proper legal groundwork for their gift card programs. As states continue to pass new laws and regulators begin to pay closer attention to how retailers market their gift cards, the risk of not complying with relevant laws becomes greater. Retailers must remain vigilant so that they can identify changes to the legal landscape and quickly adapt their gift card programs accordingly.