Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

# The Gift Card Problem For Retailers In Chapter 11

*Law360, New York (October 16, 2015, 12:34 PM ET) --*

Kenneth A. Rosen

Gift cards are very popular. They can be highly profitable for a retailer. In bankruptcy cases, the amount of outstanding gift cards can be substantial. In the Sharper Image bankruptcy case, they aggregated $19 million. At one point in the bankruptcy case of Radio Shack there were $46 million of unexpired outstanding gift cards.

Bankruptcy cases for retailers are different than other bankruptcy cases in several ways. One way is the treatment of gift certificates, gift cards, credits and refunds.

The Bankruptcy Code lays out a priority scheme for which creditors get paid before other creditors. This is called the Rule of Absolute Priority. Essentially, it is like a tower of champagne glasses. The top glass must be filled before champagne fills the second tier of glasses. And, the second tier of glasses must be filled before the third tier of glasses can be filled. Generally, the highest tier is the secured creditors' claims. If the secured creditor has a security interest in all assets of the debtor (the company in bankruptcy), then the secured creditor must be paid in full before any money is distributed to other creditors. Behind the secured creditors, but ahead of general unsecured creditors, are priority creditors.

Priority creditors are unsecured creditors who do not have collateral but get paid ahead of other unsecured creditors. Some examples are claims for customer deposits, claims for goods received by the debtor within the 20 days preceding the date of bankruptcy, claims for unpaid wages and claims for taxes. Even within the class of claims that are entitled to priority in payment, there is a ladder of priority — in other words, some priority claims get paid ahead of other priority claims.

The priority scheme of the Bankruptcy Code can be modified if the parties all agree to do so and if the modification is approved by the bankruptcy judge. Therefore, a secured creditor may allow money to flow to a creditor that is junior to it if the secured creditor thinks that, by doing so, there is benefit to the secured creditor. One example might be the secured creditors' desire to make an accommodation to the junior creditors in order to avoid future litigation and in order to bring the bankruptcy case to a more rapid conclusion. In Chapter 11 cases, the likelihood of a successful reorganization rarely increases with the age of the case. It is a rare bankruptcy case in which a party cannot find something to contest and thereby drag out the case.

In strategizing a Chapter 11 case, one of the most important things to be done by the debtor's financial adviser and attorney is to project the amount of claims likely to be asserted against the debtor. Quantifying the claims in each class is critical to formulating a repayment plan. Accurate budgeting is critical in a Chapter 11 case and knowing what the cost will be to emerge from Chapter 11 never should come as a surprise. Plans of reorganization are based on assumptions as to the cost of administration, the cost of paying priority claims and the cost of fulfilling promises to general unsecured creditors. Administration claims are claims that are entitled to be paid 100 percent — normally in cash at confirmation of the reorganization plan. Examples are professional fees and the claims of vendors who delivered goods to the debtor within the 20 days preceding bankruptcy. Payment of some priority claims such as taxes can be stretched out. A calendar of cash outflows must be developed that synchronizes with projected inflows.

When a retailer commences a Chapter 11 case creditors and lenders look at a "waterfall." That is an estimate of the value of the debtor's assets and a projection of how much value must be realized from the assets in order to pay the various layers of creditors. The debtor also takes these numbers into account in evaluating the cost of reorganizing its business. In other words, can a downsized and reorganized business generate the necessary cash flow in order to pay the claims of creditors (presumably at a negotiated discount) and also enable the reorganized debtor to have sufficient working capital for growth? Are creditors better off seeing the company liquidated than seeing the company reorganized? The first step in this analysis is determining the amount of claims in each class of creditors.

A proponent of a plan of reorganization must estimate the amount of cash needed to pay the claims that must be paid when the reorganization plan is approved (confirmed) by the Bankruptcy Court. And, the proponent must calculate the cost of the post-bankruptcy deferred payments promised to creditors. A mistake could be disastrous. Reorganization plans are premised on projected cash flow. Post-bankruptcy strategies to rehabilitate the debtor are based on assumed amounts of working capital. So, underestimating claims can cause plans to go awry.

The matter of the amount owed by a retailer on account of outstanding gift cards, refunds due, gift certificates and open credits is a big issue today in bankruptcy cases. Lately, many (if not most) retail Chapter 11 cases yield a small dividend for trade vendors. If the amount of priority claims senior to trade creditors balloons, then the amount of dollars available to pay trade creditors can evaporate.

In most bankruptcy cases, the debtor will seek permission of the court to continue honoring customer programs — such as gift cards and entitlements to refunds — as if the bankruptcy case never was commenced. The justification to the court is that, unless customers are treated in this manner, the debtor's ability to reorganize will be jeopardized. It is the same justification used to pay pre-bankruptcy employee obligations after the petition date — reorganization will be much more difficult with disgruntled employees. No debtor wants to turn off customers by telling them that their gift certificate is not being honored. Customer loyalty is jeopardized when gift cards are declined.

Most debtors should know the amount of outstanding gift cards. And, they should know the typical amount of "breakage" — the amount of gift cards that are lost and never presented. The projected amount of cards expected to be honored during the budget period (normally 13 weeks initially) affects a debtor's cash flow because all or a portion of the sales to future customer will not generate any cash. The sale proceeds previously were collected and spent. In a bankruptcy case, cash flow is paramount. Lenders, debtors and creditors committees care first and foremost about cash flow and of the debtor's ability to service bank debt, pay timely for post-petition goods and services and, especially, pay professional fees.

One should not expect a secured creditor to have much compassion for consumers with outstanding claims for gift cards. The secured lender wants to be paid first. It perceives every dollar of credit given for a gift card as a dollar less in its pocket.

In retail cases that are liquidations or “GOBs”, the question arises as to whether the professional liquidator who is conducting the liquidation sale will honor gift cards for goods sold at the GOB sale. If the liquidator must do so, there will be less cash proceeds for the debtor and its bank. Consequently, a retailer may decide (with the urging of the secured creditor) not to operate in the ordinary course while in Chapter 11 and to proceed directly to a liquidation. A retailer is more likely to be able to not to honor gift cards (and not require that the liquidator to honor outstanding gift cards) if the retailer is in a “GOB” mode.

A threat sometimes heard is that officers and directors of the debtor have individual liability for the amounts due to gift card holders. The theory, apparently, is that the money received from the sale of gift cards are trust funds that should have been segregated rather than comingled with other funds of the debtor. This is a legal theory that no prudent attorney wants to test. Debtors have dealt with this problem in different ways. Therefore, debtors may seek to amicably resolve gift card claims by agreeing to honor them in full, by honoring them for a limited time period, by honoring them provided that no “change” is given for the unspent portion of the gift card or by requiring that the holder of the gift card spend a minimum amount in order to utilize the gift card. The treatment of gift cards is driven by the needs of the case — whether the debtor deems preservation of its brand reputation as critical to continuation of the business, whether the debtor believes that preservation of its brand reputation is critical to selling its intellectual property or whether the debtor just wants to achieve the best recovery for creditors without enabling too many dollars to “come off the top.” If someone is seeking to purchase the intellectual property of another retailer in bankruptcy, knowing the treatment of gift cards, credits and refund claims in the bankruptcy case is important to understanding whether the brand’s reputation has been tarnished.

States attorneys general and also the Federal Trade Commission care strongly about gift cards. Attorneys general often will appear in Bankruptcy Court to argue in favor of consumers being given priority treatment for their gift cards before any money flows to general unsecured creditors (trade vendors). The justification is that the Bankruptcy Code treats customer deposits as priority claims pursuant to section 507(a)(7) of the Bankruptcy Code. However, not all bankruptcy courts have found that gift cards are deposits. Some have held that they only are unsecured claims.

For a retailer contemplating a Chapter 11 filing, it is important to know the amount of claims that will have to be paid before dollars can trickle down to trade creditors. Trade creditors are the primary body of creditors with whom a debtor will negotiate over a plan of reorganization. Accurately projecting the amount of allowed claims in each class directly affects the analysis of what a reorganized debtor can afford to repay creditors after bankruptcy and also retain sufficient working capital to grow the business.

Finally, when consumers become aware of a retailer’s bankruptcy, there may be a burst of utilization of gift cards. These “noncash” payments for goods must be incorporated in the cash flow projections provided to the various constituents in the case. Usually, such projections contain limited permissible variances. Meeting sales targets but missing cash flow projections places a debtor in a position of weakness vis-à-vis other constituents. Whether to honor gift cards, the risks associated with not doing so, the impact on brand value, the demands of the secured creditor and the costs of litigation all must carefully be balanced.

—By Kenneth A. Rosen, Lowenstein Sandler LLP

*Kenneth Rosen is a partner in Lowenstein Sandler's New York and Roseland, New Jersey, offices and leads the firm's bankruptcy, financial reorganization and creditors' rights practice.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*