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Feature

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Gift Cards and Their Disparate Treatment in Chapter 11 Cases

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Most retail companies that file for bankruptcy have outstanding liabilities associated with the gift cards that were issued prior to the filing. As the cards are generally given as gifts, the holders of those gift cards are for the most part untraceable. At any given time, retail companies can provide estimates of the total number of outstanding gift cards, their value and a gift certificate number.

However, what happens to the holders of these gift cards when the retail company files for bankruptcy? Very often, the retail companies seek bankruptcy court authority to continue customer programs, including honoring gift cards that were issued pre-petition, based on the theory that the gift card holders might have a priority claim under § 507(a)(7) of the Bankruptcy Code.[1] What happens when the retail company closes some or all of its stores? Will the gift cards be honored at those closing stores? Will the gift card holders get paid on account of the unredeemed gift cards after the stores close?

This article will survey two large chapter 11 retail cases in which gift card holders were treated differently. In *The Sharper Image Corp.* bankruptcy case, the holders of gift cards were recognized as having priority claims that were paid subject to following the bankruptcy court-approved procedures for submitting claims. In contrast, in the *Borders* bankruptcy case, holders of gift cards did not timely assert claims and received no distribution in the case. What accounts for the difference in treatment for gift card holders in these cases?

Case Study: *The Sharper Image*

The Sharper Image filed for chapter 11 relief on Feb. 19, 2008, in the U.S. Bankruptcy Court for the District of Delaware.[2] The Sharper Image filed a first-day motion seeking authority to honor certain customer programs, including gift cards (the "customer practices motion"), and stated that holders of gift cards issued pre-petition might be entitled to priority claims under § 507(a)(7).[3] At its first-day hearing, The Sharper Image did not seek authority to honor its gift cards.[4] A few weeks after the bankruptcy filing, The Sharper Image sought and obtained authorization to continue its gift card program in a modified manner by, among other things, (1) permitting gift card redemption only if the customer purchased merchandise equal to twice the current value of the gift card and (2) not accepting gift cards at stores that were closing unless the customer is notified at the store that gift cards are accepted.[5]

The Sharper Image did not identify the estimated amount of its outstanding gift cards in its schedules of assets and liabilities on the basis that "there is no way for [The] Sharper Image to ascertain the identity of gift card … holders or whether such cards … are still in existence."[6] As of the commencement of the chapter 11 case, The Sharper Image estimated that approximately $19.5 million worth of its gift cards were outstanding.[7]

The Sharper Image initially closed 96 stores and then later closed its remaining stores.[8] It is not clear whether gift cards were accepted at the stores that were closing, even though the agreements with the liquidators conducting the store closing sales contained a provision allowing for the liquidators to accept gift cards.[9] The Sharper Image advised its

1 "[A]llowed unsecured claims of individuals, to the extent of $2,775, for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided." 11 U.S.C. § 507(a)(7).

2 *In re The Sharper Image Corp.*, Case No. 08-10322. Docket No. 1.
3 *Id.*, Docket No. 9.
4 *Id.*, Docket No. 122.
5 *Id.*, Docket No. 189.
6 *Id.*, Docket No. 526.
7 *Id.*
8 *Id.*, Docket Nos. 135, 271, 469 and 763.
9 *Id.*, Docket Nos. 271 and 763.

customers that beginning on May 31, 2008, gift cards were no longer redeemable.[10]

In June 2008, The Sharper Image sought to establish a general bar date that would apply to pre-petition claims, including claims for outstanding gift cards (the "bar date motion"). The Sharper Image proposed to mail a gift certificate proof of claim form to each person or entity asserting a gift certificate claim if the claims agent was provided an address.[11] The Sharper Image sought to provide notice by publication of the bar date in *The New York Times* and *The Wall Street Journal*.[12] The U.S. Trustee objected to the bar date motion and filed a cross-motion to compel The Sharper Image to file schedules acknowledging gift card claims (the "U.S. Trustee objection").[13] The U.S. Trustee pointed out that The Sharper Image can run a report that lists the identification number for each gift card and the outstanding balance associated with that gift card.[14] The U.S. Trustee argued that The Sharper Image was obligated to schedule the undisputed gift card liabilities regardless of whether it could identify the card-holders.[15] The Sharper Image responded to the U.S. Trustee's objection by indicating that filing a schedule identifying each gift card by number and the amount outstanding would be lengthy and of limited usefulness to holders of gift cards.[16] The Sharper Image ultimately withdrew the bar date motion, and later TSIC Inc. f/k/a The Sharper Image Corp. (the debtor) amended its Schedule F covering unsecured claims to set forth gift card identification numbers and corresponding account balances.[17] No general bar date was established in the case.

In late June 2008, Frederic B. Prohov, who filed a proof of claim regarding his $50 gift card that was dishonored, filed a motion to certify the holders of The Sharper Image gift cards as a class (the "class certification motion").[18] The debtor and the creditors' committee negotiated the terms of an order with Mr. Prohov approving the class-certification motion that the bankruptcy court entered in September 2008.[19]

In October 2010, counsel for the gift card class representative filed a motion for summary judgment seeking resolution of whether the gift card class was entitled to priority treatment for their gift card claims, now that it appeared that the estate was not administratively insolvent.[20] The gift card class representative asserted that cardholders were entitled to priority treatment as "deposits" under 11 U.S.C. § 507(a)(7).[21]

On April 11, 2011, the debtor filed a motion seeking to establish procedures for settling the claims of gift card holders.[22] After a contested hearing, the bankruptcy court approved procedures that required providing notice of the deadline to submit gift card claims by (1) placing teasers on websites, including Facebook, and (2) advertising in *People* and *Sports Illustrated*.[23] Ultimately, gift card claimants who could provide a copy of their gift card received 100 percent recovery.[24]

Numerous factors led to the favorable treatment of gift card holders in the *The Sharper Image* case. One factor was the change in the treatment of gift card redemption during the case that likely contributed to the request for class certification within a few months of the filing. Another factor was the opposition from the U.S. Trustee and the ultimate gift card class representative to The Sharper Image's request to set a general bar date covering gift card claims. The Sharper Image ultimately withdrew its request to set a general bar date, and as a result, it was not able to reduce its gift card liability through a general bar date process that would have relied for the most part on a publication notice to gift card claimaints. Another factor leading to the favorable treatment of the gift card claimaints was that there were sufficient funds in the estate to pay the allowed priority gift card claims despite the fact that all the brick-and-mortar stores closed.

Case Study: *Borders*

On Feb. 16, 2011, Borders Group Inc. and its affiliated debtors (collectively, "Borders") filed for chapter 11 relief in the U.S. Bankruptcy Court for the Southern District of New York.[25] As part of their first-day relief, Borders sought and obtained approval to continue their customer programs, including honoring gift cards, based in part on the argument that the holders of gift cards may have priority claims under § 507(a)(7).[26] Borders estimated that the amount on its unredeemed gift cards was approximately $275 million as of the end of January 2011.[27]

Borders sought and obtained approval of a general bar date for pre-petition claims (the "bar date application").[28] The order required Borders to serve notice of the bar date by mail upon known holders of claims and publish notice of the bar date in *The New York Times* to cover unknown creditors.[29] There was no mention of gift card claims in the bar date application.

Borders' schedules of assets and liabilities indicated that they had "excluded liabilities paid under orders [that were] entered by the Bankruptcy Court permitting the Debtors to pay certain pre-petition liabilities ... to the extent known."[30] It does not appear that Borders listed any gift card liabilities in their schedules. As of June 2011, the estimated unredeemed balance on Borders gift cards was approximately $210.5 million.[31]

In July 2011, the bankruptcy court authorized Borders to conduct going-out-of-business sales at all of its locations,[32] and this sale order provided that the Borders gift cards issued prior to the start of the store closing sales were to be honored at the closing stores.[33] The store closing sales

10 *Id.*, Docket No. 2218.
11 *Id.*, Docket No. 799. Some gift card holders had provided their address to the claims agent and in some cases, the claims agent had obtained an address from the customer complaints that were filed with local or state agencies and bureaus. *Id.*
12 *Id.*
13 *Id.*, Docket No. 926.
14 *Id.*
15 *Id.*
16 *Id.*, Docket No. 997.
17 *Id.*, Docket Nos. 1062 and 1136.
18 *Id.*, Docket No. 964.
19 *Id.*, Docket Nos. 1260 and 1264.
20 *Id.*, Docket No. 2111.
21 *Id.* (citing *In re WW Warehouse Inc.*, 313 B.R. 588 (Bankr. D. Del. 2004)).
22 *Id.*, Docket No. 2218.
23 *Id.*, Docket No. 2243.
24 *Id.*, Docket No. 2392.
25 *In re Borders Group Inc., et al.*, Case No. 11-10614 (Bankr. S.D.N.Y. 2011), Docket No. 1.
26 *Id.*, Docket Nos. 18 and 63.
27 *Id.*, Docket No. 18.
28 *Id.*, Docket Nos. 475 and 580.
29 *Id.*, Docket No. 475.
30 *Id.*, Docket No. 491.
31 *In re BGI Inc., f/k/a Borders Group Inc.*, 476 B.R. 812, 820, 825 (Bankr. S.D.N.Y. 2012).
32 *In re Borders Group Inc., et al.*, Case No. 11-10614, Docket No. 1377.
33 *Id.*

ended in September 2011.[34] On Dec. 21, 2011, the court confirmed the Borders liquidation plan, which went into effect on Jan. 12, 2012.[35]

On Jan. 4, 2012, certain holders of Borders gift cards filed a motion (the "late-claim motion") seeking authority to file late claims on the basis that they did not receive adequate notice of the bar date and that they qualify as "known" creditors who should have received actual notice.[36] A few days later, these gift card holders filed a motion (the "class-action motion") seeking (1) certification of a class covering all holders of pre-petition Borders gift cards and (2) allowance of a class claim, along with priority status for the class claim.[37]

The bankruptcy court denied the late-claim motion, finding that the gift card holders were not "known" creditors, and therefore, Borders was not required to give them direct and actual notice of the general bar date.[38] The court found that the gift card holders' failure to timely file claims did not constitute excusable neglect.[39] Since the bankruptcy court denied the late-claim motion, it determined that the class-action motion was moot.[40]

The gift card holders appealed the bankruptcy court's decision to the U.S. District Court for the Southern District of New York,[41] which noted that the bar date passed and that no proofs of claim were filed by any of the millions of gift card holders.[42] In addressing equitable mootness, the district court stated:

> While there is room for debate regarding how notice should be sent to gift card holders if the Court reopens the period to file claims, it seems apparent [that] a solution could be devised to provide notice that is more targeted than publication. Whether an email to Borders' broader customer base, social media platforms, or some other form of communications would appropriately meet due-process requirements is an open question.[43]

The district court found that the appeals were equitably moot, and as a result, the district court did not need to reach the merits of the underlying appeals.[44] The proposed class representative for the gift card claimants got involved too late in the *Borders* case to make a difference for the holders of unredeemed gift cards. In contrast to *The Sharper Image* case, there was no representative challenging the bar date, filing a claim or seeking class certification in the early stages of the *Borders* case. Although gift cards could be used at the Borders stores that were closing, no proofs of claim were filed by gift card claimants by the bar date, so they had no remedy for payment after the stores closed (even though there were funds to pay priority creditors under the liquidating plan).

Conclusion

The comparison of the treatment of gift card holders in *The Sharper Image* and *Borders* cases raises the question of whether a published notice via national newspapers is the best way to notify potential gift card claimants. As noted by the district court, "[I]t seems apparent [that] a solution could be devised to provide notice that is more targeted than publication."[45] In *The Sharper Image* case, the gift card class representative, the debtor and the creditors' committee negotiated the appropriate notice to potential gift card claimants that included a combination of print publication and online media campaigns as a means to reach potential gift card holders. Even if the ultimate gift card holders are unknown, maybe the standard publication notice in *The Wall Street Journal* and/or *The New York Times* is not sufficient to satisfy due-process requirements for gift card claimants. **abi**

34 *Id.*, Docket No. 2110.
35 *Id.*, Docket Nos. 2384 and 2465.
36 *Id.*, Docket No. 2415
37 *Id.*, Docket No. 2450.
38 *In re BGI Inc.*, 476 B.R. at 826-27.
39 *Id.* at 826.
40 *Id.* at 826-27.
41 *In re BGI Inc., f/k/a Borders Group Inc.*, Case 1:13-cv-0080-ALC, (S.D.N.Y. 2013), Docket No. 16.
42 *Id.*, Docket No. 16.
43 *Id.*
44 *Id.*
45 *Id.*

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