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Feature

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Solving the Gift Card Conundrum

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Retail debtors and consumers have long debated the appropriate treatment for claims on account of unredeemed gift cards. The facts giving rise to the debate, and the competing legal positions, are quite simple and easy to place into context. Consumer X purchases a gift card from Retail Debtor Y. However, before Consumer X (or his/her subsequent transferee) uses the gift card, Retail Debtor Y files for bankruptcy. Retail Debtor Y enters into a consulting agreement with a liquidation consortium, which promptly commences going-out-of-business (GOB) sales. Previously purchased gift cards are honored at the GOB sales, but many go unredeemed by the time the GOB sales have been concluded.

Having lost the ability to use the gift card, Consumer X submits a claim in the bankruptcy case to recover the lost value.[2] The claim is submitted as a "deposit" priority pursuant to § 507(a)(7) of the Bankruptcy Code, which affords priority treatment for claims of individuals (up to $2,775 per individual) "arising from a 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."[3] Retail Debtor Y objects to the claim on the basis that payment in return for a gift card is not a true "deposit" within the meaning of the statute and seeks to have Consumer X's claim reclassified as general unsecured in nature. Consistent with the current trend, Retail Debtor Y's bankruptcy proceeding is riddled with underwater secured creditors fighting to squeeze every dollar from their collateral, and priority claims are the only class of unsecured claims likely to receive a full recovery. Therefore, Consumer X's ability to recover the value lost on account of the unredeemed gift card turns entirely on whose interpretation of the word "deposit" is correct.

On Aug. 4, 2016, Hon. **Kevin Gross** of the U.S. Bankruptcy Court for the District of Delaware sided with Retail Debtor Y in *In re City Sports Inc*.[4] The court's opinion is at odds with prior decisions in Delaware and elsewhere, and while consistent with certain decisions in other districts, it will undoubtedly impact future bankruptcies filed in Delaware and beyond. This article provides a summary of the competing legal positions, certain prior case law and the bankruptcy court's decision in *City Sports*.

The Parties' Positions

Founded in 1983, City Sports Inc. was a Boston-based athletics retailer that sold its products through retail stores in Massachusetts, Rhode Island, New York, Pennsylvania, Maryland, New Jersey and Vermont.[5] Facing an increasingly challenging retail environment, City Sports commenced a chapter 11 proceeding on Oct. 5, 2015, pursuant to which it closed all of its stores and liquidated all assets.[6] Prior to filing for bankruptcy, City Sports sold pre-paid gift cards to consumers.[7] At the conclusion of its GOB sales, City Sports estimated that gift cards totaling approximately $1.18 million remained unredeemed.

The Commonwealth of Massachusetts submitted a claim on behalf of Massachusetts residents for the full amount of City Sports' unredeemed gift cards.[8] Like Consumer X in the hypothetical, the Commonwealth sought priority status for its claim under § 507(a)(7). In support of its argument, it cited *In re WW Warehouse Inc*.,[9] wherein, under

1 Any opinions expressed and any legal positions asserted in this article are those of the authors and do not necessarily reflect the opinions or positions of Bayard, PA or its other lawyers.
2 The authors acknowledge that adequate notice and due process are threshold issues common to this dispute. This article assumes that Consumer X received proper notice of Retail Debtor Y's bankruptcy proceeding and the attendant claims process.
3 11 U.S.C. § 507(a)(7).
4 *In re City Sports Inc*., 554 B.R. 329 (Bankr. D. Del. 2016).
5 *Id.* at 331.
6 *Id.*
7 *Id.*
8 *Id.* at 331-32.
9 *In re WW Warehouse Inc*., 313 B.R. 588, 595 (Bankr. D. Del. 2004).

similar circumstances, the court found unredeemed gift certificates to be true "deposits" that must be paid on a priority basis pursuant to § 507(a)(7).

City Sports, with the support of the unsecured creditors' committee, objected to the Commonwealth's claim and predictably argued that gift cards do not constitute customer deposits within the scope of the statute. According to City Sports, a "deposit" only occurs when a party provides money in return for the promise of the depositee to hold the money in trust (*e.g.*, on account of a partial payment for a particular piece of merchandise or in a layaway transaction). By focusing on the temporal relationship between the time that consideration is given and the time that the right to use the product is vested in the consumer, City Sports asserted that the purchase of a gift card cannot possibly constitute a deposit since the transaction is completed in a single step. In other words, upon receipt of the gift card, the consumer received exactly what he/she bargained for and no additional actions were required to close the transaction. City Sports underscored this argument by noting that § 507(a)(7) limits priority treatment to claims arising in those situations where the relevant product was not "delivered or provided" at the time of payment.[10]

Prior Decisions Interpreting § 507(a)(7)

A brief overview of the key decisions interpreting the "deposit" requirement of § 507(a)(7) is instructive in analyzing the *City Sports* decision. Since 2004, *WW Warehouse* has been cited in practically every § 507(a)(7) dispute between retailers and consumers over the treatment of gift cards. Much like City Sports, *WW Warehouse* argued that gift certificates represent paid-in-full transactions, not deposits that can only arise in the context of a partial or down payment for a future purchase of a specific good.[11] However, the *WW Warehouse* court declined to limit the definition of a "deposit" to a partial payment of a purchase price for specific merchandise.[12] Rather, in granting priority status to the claims, the court found that "consumers do not purchase gift certificates ... as the ultimate purchase," but instead "expect merchants to apply to some or all of the face value of the gift certificate toward the ultimate purchase."[13]

In 2005, the Ninth Circuit in *In re Salazar*[14] likewise granted priority status to creditors who paid the full purchase price for a pool that was not finished by the debtor prior to filing for bankruptcy.[15] The dispute centered on whether a payment in full removed the transaction from the "deposit" definition. Siding with the creditors, the Ninth Circuit noted that it is "highly unlikely that in drafting [§ 507(a)(7)], Congress intended to protect consumers who had been induced to pay ... a portion of the purchase price in advance, but not those who were induced to pay ... the whole amount."[16] Thus, *Salazar* expanded, albeit slightly, the *WW Warehouse* decision by according priority status to consumers whose "deposits" were actually payment in full for specified goods.

In contrast, the support for the Commonwealth's position begins with the Eighth Circuit's decision in *In re Northwest Financial Express Inc*.[17] In that case, the debtor marketed money orders through grocery and convenience stores, which in turn sold the money orders to their customers and remitted the proceeds to the debtor. The money orders purchased by each individual were transferrable and, according to the consumers, constituted a deposit. The Eighth Circuit disagreed and found that the purchase of a money order was "more akin to the purchase of a product (a transferable instrument) for immediate delivery which product is tradeable in lieu of cash."[18] As such, the court believed that the consumers got exactly what they bargained for (*i.e.*, the money order) immediately upon payment.[19] Similarly, the *In re Heritage Village Church & Missionary Fellowship*[20] court found that pre-petition donations in return for membership benefits such as hotel accommodations were not deposits within the meaning of § 507(a)(7).[21] Like the money orders at issue in *Northwest Financial Express*, the court held that the "benefits" of membership were delivered and provided immediately upon completion of the transaction, which prevented the payment from being considered a true "deposit."[22]

The same rationale was applied in *In re Nittany Enterprises Inc.*,[23] where the debtor offered its members access to "confidential inside prices."[24] The claimant entered into a membership agreement with the debtor pre-petition and filed a proof of claim on the basis that he "paid $6,000 for services and received nothing."[25] The court held that "the term 'deposit' connotes a temporal relationship between the time consideration [has been] given and the time the right to use or possess is vested in the individual giving the consideration."[26] Finding that the claimant's right to use the membership vested immediately, the court denied the claimant's attempt to be paid on a priority basis.[27]

Finally, in *In re Utility Craft Inc.*, the U.S. Bankruptcy Court for the Middle District of North Carolina rejected a creditor's priority status argument on account of an unredeemed store credit.[28] In *Utility Craft*, the creditor ordered a couch from the debtor and paid an initial deposit.[29] Upon delivery, the creditor paid the balance, but because the couch was defective, the creditor returned the couch in exchange for store credit.[30]

The debtor filed for bankruptcy before the creditor redeemed the credit, and the creditor filed a proof of claim asserting (in part) priority status.[31] Applying the reasoning from *WW Warehouse*, the creditor argued that the claim should be accorded priority status because it arose from

10 11 U.S.C. § 507(a)(7). In further support of its argument, *City Sports* relied on a transcript ruling from *RadioShack*, where Hon. **Brendan L. Shannon** criticized the *WW Warehouse* decision as having been incorrectly decided. *In re RS Legacy Corp.*, 2016 WL 1084400, at 1* (Bankr. D. Del. March 17, 2016). Indeed, the bulk of *City Sports*'s argument was taken from, with Judge Gross's permission, the briefs submitted by the debtors and committee in *RadioShack* in support of an identical position.
11 *In re WW Warehouse Inc.*, 313 B.R. at 590-91.
12 *Id.* at 593-95.
13 *Id.* at 595.
14 *Salazar v. McDonald (In re Salazar)*, 430 F.3d 992 (9th Cir. 2005).
15 *Id.* at 994.
16 *Id.* at 995.
17 *Northwest Fin. Express Inc. v. JWD Inc. (In re Northwest Fin. Express Inc.)*, 950 F.2d 561, 563 (8th Cir. 1991).
18 *Id.*
19 *Id.*
20 137 B.R. 888 (Bankr. D.S.C. 1991).
21 *Id.* at 896.
22 *Id.*
23 *In re Nittany Enters. Inc.*, 502 B.R. 447 (Bankr. W.D. Va. 2012).
24 *Id.* at 450-51.
25 *Id.*
26 *Id.* at 455 (citing *In re Palmas Del Mar Country Club Inc.*, 443 B.R. 569, 575 (Bankr. D.P.R. 2010)).
27 *Id.* at 456.
28 *In re Util. Craft Inc.*, 2008 WL 5429667, at *4 (Bankr. M.D.N.C. 2008).
29 *Id.* at *1.
30 *Id.*
31 *Id.*

the initial deposit.[32] In deciding that the store credit did not qualify as a deposit within the ambit of § 507(a)(7), the court followed the reasoning of *Northwest Financial Express*. Specifically, the creditor paid a deposit, received the couch and paid the remaining balance owed at the time of delivery.[33] According to the court, "neither the statute, nor the legislative history, contemplates the statute's application when a product is purchased, discovered to be defective, and then returned" because the fact remains that, with the issuance of the store credit in exchange for the defective sofa, the consumer immediately received the benefit of his/her bargain.[34]

The *City Sports* Opinion

Faced with a body of conflicting case law, Judge Gross first looked to the plain language of § 507(a)(7), more specifically to the meaning of the term "deposit."[35] Finding that gift cards are not "deposits" within the scope of § 507(a)(7), Judge Gross followed the reasoning from *Nittany Enterprises* that "'deposit' connotes a temporal relationship between the time consideration [has been] given and the time the right to use or possess is vested in the individual giving the consideration."[36] By utilizing a temporal analysis, one can discern a distinction between consideration tendered as a true deposit (*e.g.*, in an incomplete transaction where the goods or services were not delivered or provided) and a mere payment for goods or services.[37] According to the court, a gift card transaction is complete upon payment, as the benefit of the consumer's bargain is immediately conferred by the receipt of a gift card.

The court analogized its rationale to the holdings in *Northwest Financial Express* and *Utility Craft*.[38] According to the court, the features of the money orders at issue in *Northwest Financial Express* were identical to those City Sports' gift cards in that both were purchased for cash in a transaction where the consumer immediately received the benefit of his/her bargain in the form of a freely transferable instrument.[39] Likewise, the transaction in *Utility Craft* was complete upon the issuance of a store credit that included the initial deposit.[40] The fact that the consumers in those cases and the gift card holders in *City Sports* failed to use the instrument prior to the retailer's bankruptcy is irrelevant to the inquiry.

In holding that gift cards are not entitled to priority status, Judge Gross criticized the *WW Warehouse* decision for incorrectly focusing on "the ultimate purchase" as "an amorphous concept with potentially unlimited temporal extension."[41] The court instead focused on the limited nature of the transaction, noting that "the purchase of a gift card is a short transaction, without a temporal relationship: the consumer makes payment and simultaneously receives the gift card."[42] Finding that the purchase of a gift card is "akin to the purchase of a product (a transferable instrument) for immediate delivery," the court refused to apply a potentially unlimited transactional duration to gift card purchases, which it found to be a completed transaction upon issuance of the instrument.[43] Thus, the court concluded that gift cards cannot constitute the type of deposits that are afforded priority status.[44]

> ***City Sports* makes sense and resolves what has been a contentious issue for debtors in a variety of industries, most notably retail, grocery and dining.**

Conclusion

Conceptually and practically, the court's decision in *City Sports* makes sense and resolves what has been a contentious issue for debtors in a variety of industries, most notably retail, grocery and dining. Gift card transactions are commercially distinct from true deposits in several important respects. As noted in *City Sports* and earlier decisions, the right to use a gift card vests immediately upon purchase, whereas a true deposit requires at least one additional step for the transaction to be complete (*i.e.*, delivery of the good). Gift cards are also freely transferable — hence the name "gift card" — and do not entitle the purchaser to a right of refund as might be the case with other consumer deposits. Conferring priority status on a claim arising from a transaction that is materially different from a true deposit does not advance the consumer-protection principles discussed in the legislative history of § 507(a)(7), which pertain primarily to payments on layaway plans or contracts with future services to be rendered, circumstances that are wholly absent from a gift card transaction.

A large priority claims pool can wreak havoc on a debtor's ability to confirm a plan in a chapter 11 case. The *City Sports* decision is a positive development for debtors looking to avoid costly litigation with unredeemed gift card holders and for unsecured creditors hoping to receive a meaningful distribution on account of their claims.[45] abi

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32 *Id.*
33 *Id.* at *4.
34 *Id.*
35 *In re City Sports*, 554 B.R. at 334-38.
36 *Id.* at 335 (quoting *In re Nittany Enters. Inc.*, 502 B.R. 447, 455 (Bankr. W.D. Va. 2012)).
37 *In re City Sports*, 554 B.R. at 335.
38 *Id.* at 336-37.
39 *Id.* at 336.
40 *Id.* at 337.
41 *Id.* at 335 (citing *In re WW Warehouse*, 313 B.R. at 595).
42 *Id.*
43 *Id.* at 336-37 (quoting *In re Northwest Fin. Express Inc.*, 950 F.2d at 563.
44 *Id.*
45 At the time that this article was written, the Commonwealth had not appealed the court's decision but had filed a motion for reconsideration.