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Beware strangers bearing gift cards

Some wholesale advice for your retail clients

By Judith Rinearson and Chris Woods

With all of the new gift cards in the marketplace today, you would think that the process of turning paper gift certificates into a plastic card program would be easy. Indeed, you'll find many processors looking for business and pitching the proposition that retailers can quickly benefit from converting their various paper check or paper certificate programs into plastic. But this is one area where you should look carefully before you leap.

One unlucky retailer announced a gift card program with great fanfare, only to find its gift cards on the wrong end of a consumer watchdog television program. Much to this retailer's chagrin, its gift card program violated a little known state law prohibiting expiration dates on gift certificates. The new gift card program not only garnered unfavorable publicity for the company, but it also exposed the company to potential class action liability.

The retailer, however, thought it was on solid ground because its gift card program was similar to so many others. The owner figured, "If everyone else is doing the same thing, it must be OK." Unfortunately, when it comes to these programs, there is no safety in numbers. In fact, there is little a state attorney general likes better than to issue a press release denouncing 20 or more local retailers for consumer-unfriendly gift card programs.

But the owner was partially correct — gift cards seemingly *are* everywhere these days. A recent survey revealed that 45 percent of adult Americans purchased a gift card in 2003. One company projects that sales of gift cards will exceed $72 billion by 2006.

And for good reason. To consumers, gift cards are little more than the modern form of gift certificates; but to merchants, gift cards are far superior to their paper counterparts. Because gift cards do not require paper- based settlement, gift-card transactions are easier to clear and settle. Gift cards also can store the value remaining after each use, so retailers don't have to provide change back after a purchase. Further, gift cards enable merchants to gather data about consumers' use of the cards, providing important marketing information.

Finally, as Starbucks knows well, gift cards increase customer loyalty. Since launching its gift card program in 2001, Starbucks has seen more than 100 million redemptions on its reloadable gift cards, and today 10 percent of all of Starbucks sales are paid for using gift cards.

But this explosion in the use of gift cards has caused state and federal regulators, including attorneys general, state consumer affairs offices, the Treasury Department, and the FDIC to start paying attention. Newspaper articles, press releases and TV news reports also have spread the word.

At the same time, the laws governing these products, which lay at the intersection of abandoned property laws, money transmitter licensing laws, and anti-money-laundering laws, are undergoing significant changes. With bills pending in more than half the state legislatures (15 bills in New York state alone), it's all the more important to understand the basic rules underlying these products. To get you started, we've come up with a list of some of the most often asked questions you'll hear from clients who may be interested in this growing industry.

Do businesses need a license to issue or sell gift cards? It depends on the kind of gift card involved. *(See sidebar on their wide world.)* The overwhelming majority of gift cards are closed-system cards. Currently, no license is required either to issue or sell closed-system gift cards. However, should your client issue or sell semi-closed or open-system cards, it may run into licensing concerns.

At this time, 16 states clearly require issuers of prepaid cards — other than closed-system retailer cards — to obtain a money transmitter license or similar license. While some of these states provide exceptions for bank issuers and for other narrow categories of cards (such as point-based "reward cards"), at the time of writing, the following states have amended their money transmission laws to require licensing of store-valued products: Connecticut, District of Columbia, Illinois, Iowa, Louisiana, Maryland, Minnesota, Mississippi, North Carolina, Oregon, Texas, Vermont, Virginia, West Virginia, Washington and Wyoming.

Other states have said that their existing laws may cover certain prepaid cards without the need for an amendment. Should your client wish to issue a semi-closed or open-system card, you should check local money- transmitter laws carefully. Even if your client wishes only to sell a card issued by someone else, your client should make sure that the issuer has an appropriate license, if necessary, and has appointed your client as its agent or representative to sell the cards in that state.

Whatever you do, don't let your client be tempted to forego licensing if it's required by a state in which it does business. It's a federal crime to do business as a "money transmitter" without a license in a state that requires licensing. 18 U.S.C. § 1960 states: "Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business, shall be fined in accordance with this title or imprisoned not more than five years, or both." Moreover, a violation of this law can occur "whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable."

What anti-money-laundering laws apply to gift cards? Currently not many, but again, the answer depends on the type of prepaid card involved. The answer also depends on whether your client is a "money services business," or "MSB" under federal law. MSBs are nonbanks in the financial services business, such as wire transfer companies and money order issuers. The term also includes issuers, sellers and redeemers of stored value who do more than $1,000 of stored value business per person per day. Although the $1,000 threshold effectively excludes most gift card issuers, beware that multiple transactions with any one person are aggregated to determine the threshold.

At this time, the regulations provide that persons who are MSBs solely because they issue, sell or redeem stored-value are required to have an anti-money-laundering compliance plan and file currency transaction reports (CTRs) for cash transactions greater than $10,000. (If your client is not a financial institution, it will need to file Form 8300 with the IRS instead.)

For now, it appears that issuers of disposable, fixed- denomination gift cards don't need to worry about a major aspect of the USA PATRIOT Act: customer identification. But if your client issues open-system reloadable prepaid cards, this requirement can be a major concern — not just for anti-money laundering reasons, but for fraud prevention too. There is substantial regulatory interest in the potential use of prepaid cards for money laundering, and while current regulations may not directly apply to these products, more regulations are expected.

What state abandoned-property laws apply? The answer is not always clear. In general, to know which state's abandoned-property laws apply, you look to the state where the cardholder resides. If you do not know the residence of the cardholder, you look to the state of incorporation of the card issuer. Still, even when it's clear what state's abandoned-property laws apply, you may not be out of the woods.

The difficulty is that most states have not amended their abandoned-property laws to expressly address gift cards. Nor have any courts clearly stated whether abandoned-property laws relating to "gift certificates" apply to gift cards. Although the current trend is for states to amend their abandoned- property laws to cover gift cards rather than attempting to apply existing gift-certificate laws, it's still a gray area.

Among the states that have already amended their abandoned-property laws to cover gift cards, some, such as North Carolina and Illinois, exclude gift cards from their abandoned property laws *provided* there is no expiration date or servicing fee. Others, such as Maine and Virginia, specifically require issuers to pay the state when gift card funds are abandoned.

Finally, there is Connecticut, which not only imposes abandoned-property obligations on gift cards, but has taken its laws one step further to maximize the state's abandoned-property revenues: If the issuer does not know the residence of the gift card owner, then such residence is deemed to be the Connecticut state treasurer's office.

Can companies charge "servicing/dormancy" fees or impose expiration dates? In most states yes, but this is changing. Dormancy fees (fees debited from a card — usually on a monthly basis — when it is not used before a specified period), servicing fees (monthly fees debited from a card for "services" that do not require any period of nonuse), and expiration dates have all been criticized as a way for card issuers simply to make more money from consumers who buy gift cards that are not fully used. This can be significant dollars, given that roughly 10 percent of the funds used to purchase gift cards (estimated at $44-$77 billion) is never redeemed.

Because of increasing consumer complaints, these fees and expiration dates have become a hot issue for lawmakers. A number of states have passed laws concerning gift card fees or expiration dates and many others have legislation pending. The problem for issuers is that these laws often differ dramatically. For instance:

- California: For closed system ("single store") gift cards, expiration dates and service fees may not be imposed. Dormancy fees are permitted only if (1) the value remaining is $5 or less; (2) the fee does not exceed $1 per month; (3) there is no activity for 24 months; (4) the cardholder may add value; and (5) the fees are clearly disclosed.
- Maine: Gift cards cannot expire. Issuers may impose fees only if the fees are noted on the card, are regularly imposed according to a written contract, and are

not unconscionable.

- Massachusetts: Gift cards must be valid for seven years. Expiration dates must be clearly marked on the card or a sales receipt or made available over the phone or the Internet.
- Washington: Closed system ("single store") gift cards cannot have an expiration date nor any fees, including servicing fees, but if compliant with these restrictions, then abandoned property laws do not apply.

This is a hot area for regulators and more state laws in this area are anticipated.

Do issuers have to provide refunds for lost/stolen gift cards or allow for cash redemption? Presently there are no laws requiring gift card issuers to provide refunds for lost or stolen cards. Instead, these matters typically are governed by each issuer's cardholder agreement. However, this too is changing, due in large part to the efforts of New York Attorney General Eliot Spitzer.

When a cardholder complained about not being able to get a refund, despite a receipt and proof of purchase, an investigation of Home Depot's gift card program ensued. Home Depot agreed to reform its policies to provide for the replacement of lost/stolen gift cards up to the amount still remaining on the cards on proof of purchase. Subsequently, Spitzer obtained commitments from 18 other national retailers to implement similar changes. Facing competitive pressure and heightened publicity, numerous other merchants have followed suit.

With respect to redemption, most gift card issuers redeem gift cards for merchandise or services, but not for cash. But this practice is also coming under scrutiny. Although there are no laws requiring *replacement* of lost or stolen cards, there has been some lawmaking concerning *cash redemption*. For example, in Massachusetts, if more than 90 percent of a gift card's value is redeemed, the remainder must be redeemable in cash.

What happens when a gift card issuer becomes insolvent? The Bankruptcy Code does not afford gift card holders special protection. While many open-system cards are structured to ensure that funds on the cards are held in trust for the cardholder, generally this is not the case with closed-system gift cards. Accordingly, in the event of a gift card issuer's bankruptcy, cardholders will be treated as unsecured creditors, and their prospects for recovery often depend on whether the case is a Chapter 7 or Chapter 11 bankruptcy.

In reorganizations, issuers often seek to honor gift cards to maintain goodwill; however, card issuers may limit redemption to a limited time frame. In Chapter 7 cases (and Chapter 11 cases where the bankruptcy court denies authority to redeem gift cards), a cardholder's only option is to file a proof of claim.

Gift card laws in California, New York and Washington intend to change this result. These states' laws provide that a bankrupt gift card issuer must honor gift cards issued prior to the bankruptcy filing. More states are considering similar legislation.

Is there a difference in regulation depending on whether a gift card is issued by a bank versus a nonbank? Yes. First, and most notably, most banks (especially national or federally chartered banks) would not need to obtain a "money transmitter" license in order to issue open or semi-open system prepaid gift cards. However there are also certain regulations unique to banks and other traditional financial institutions. Two issues that warrant close monitoring are FDIC deposit insurance and federal preemption.

In 1996, the FDIC's general counsel issued an opinion stating that funds representing value on prepaid cards are not deposits under the Federal Deposit Insurance Act except in limited situations. Accordingly, funds backing most prepaid cards are not FDIC insured. However, in April 2004, the FDIC published for comment a proposed rule that would treat virtually all funds backing prepaid cards as deposits. Response to this proposed rule has been mixed, with many large financial institutions urging further study. At the time of writing, the FDIC has made no other action. "Final action" is scheduled for October, 2004.

For insured depository institutions issuing prepaid cards, treating these funds as deposits implicates not only deposit insurance, but also reserve requirements and potentially Regulation E to the Electronic Funds Transfer Act. On Sept. 13, the Federal Reserve issued a proposal to extend Regulation E to cover payroll cards but not other prepaid cards; however, it is always a good idea to consider compliance with the Regulation E requirements, especially for "Open System Prepaid Cards."

The continuing controversy concerning the preemption regulations issued by the Office of the Comptroller of the Currency also is of importance for national banks in the gift card business. Some national banks that issue prepaid gift cards have taken the position that state laws restricting dormancy/servicing fees or expiration dates do not apply to their bank-issued gift cards because of federal preemption.

State regulators have fiercely opposed any position that would limit the effect of state consumer protection laws. For example, Connecticut's attorney general issued a press release early this year noting, "This arrogant, appalling effort to usurp legitimate state consumer protection laws will be challenged by Connecticut and other states and should be promptly struck down by the courts or by Congress. We will sue the OCC if necessary to protect state laws that safeguard our vital economic and consumer interests, and a tradition of dual regulation that has existed for more than a century." In addition, congressional leaders and consumer advocates alike have attacked the preemption rules as being bad for consumers.

In short, the world of prepaid cards is complex and changing. So, the next time a stranger arrives at your client's door, offering entry into the lucrative world of gift cards — advise caution. Gift card programs are not simple. They need to be carefully structured to comply with local laws. However, when they're done right, they can make your clients and their customers very happy indeed.

The wide world of prepaid cards

Prepaid (or "stored value") cards are plastic cards with magnetic stripes or an embedded chip that resemble a credit card. But they are "prepaid" and do not involve credit at all. That is one reason the cards are popular with young people and with those persons who cannot obtain credit. The purchaser must pay in advance to have a certain amount of money "loaded" or assigned to the card. The card can then only be used up to the amount that has been prepaid. For example, if someone purchases a $25 prepaid card and tries to use it to make a $30 purchase, the purchase will be declined.

Gift cards are but one species of prepaid cards. Although most prepaid cards look similar, the types of prepaid cards vary widely. Broadly, prepaid cards can be grouped into four categories:

- *Closed-system cards.* Typically gift cards, these cards can be used only at the merchant who issues them and are sold in fixed amounts. The Barnes & Noble cards or Starbucks cards are both examples of closed-system gift cards.
- *Semi-closed-system cards.* These cards can be used at multiple merchants, often within a specific geographic area, and usually are issued by a third party other than the retailer who accepts them. Examples are mall gift cards and university cards.
- *Open-system purchasing cards.* These cards are similar to semi-closed system cards but generally can be used nationwide either at a category of merchants (such as restaurant cards or gasoline station cards) or at retailers (such as "universal gift cards"). These cards are accepted at merchants (including Internet retailers) through existing credit card networks and are good only for purchasing goods or services; they do not provide cash access.
- *Open-system prepaid cards.* These cards function more like traditional debit

cards. Some can be used only at ATMs and PIN-based point of sale terminals. Others combine ATM access with the ability to make purchases at a wide range of merchants and retailers. Prepaid cards, such as CitiCash cards, American Express TravelFunds cards, and VisaBuxx cards, are an example. Payroll cards (used by employers in place of paychecks) are another growing category of open system prepaid cards.

Important: This article focuses on the simplest prepaid cards — the closed and semi-closed cards. *The legal issues surrounding open-system cards are significantly more complex and cannot be addressed here.*

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Want more information?

- On anti-money laundering compliance, see www.msb.gov
- On abandoned-property laws, see www.unclaimed.org and www.uphlc.org
- On state money-transmitter laws, see www.mtraweb.org
- On the Federal Reserve Board's proposed extension of Reg E, see www.federalreserve.gov/boarddocs/press/ bcreg/2004/20040913/default.html
- On the regulation of the prepaid card industry generally, see the Philadelphia Fed Payment Center paper posted at http://www.phil.frb.org/pcc/papers/Prepaid_Cards.pdf

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