GIFT CARDS AND LOYALTY PROGRAMS IN FRANCHISE SYSTEMS

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Table of Contents

I. INTRODUCTION ......................................................................................................................... 1

II. GIFT CARDS ............................................................................................................................. 2
   A. Legal Framework ..................................................................................................................... 2
      1. Federal Regulation: The Credit CARD Act ................................................................. 3
         a. Disclosure Requirements .......................................................................................... 3
         b. Expiration Provisions ............................................................................................... 4
         c. Fees ............................................................................................................................ 4
         d. Effect on State Laws .................................................................................................... 5
      2. State Regulation ................................................................................................................ 5
         a. Disclosure Requirements .......................................................................................... 5
         b. Expiration Dates ........................................................................................................ 6
         c. Fees ............................................................................................................................ 7
         d. Escheat ....................................................................................................................... 8
         e. Redemption for Cash Requirements .......................................................................... 10
         f. Pending Legislation ..................................................................................................... 11
      3. Inter-Jurisdiction Issues .................................................................................................... 12
         a. Relationship Between Federal and State Regulations ............................................. 12
         b. State vs. State Escheat ............................................................................................... 13
   B. Implementation and Operations Issues ............................................................................ 14
      1. Deciding Whether to Implement a Gift Card Program .............................................. 15
         a. Costs of Implementation .......................................................................................... 15
         b. Benefits of Implementation ..................................................................................... 15
      2. How to Implement a Gift Card Program (Legally Speaking) ...................................... 16
         a. Current Franchisees ................................................................................................. 16
         b. Prospective Franchisees .......................................................................................... 17
i. Franchise Agreement .................................................. 17

ii. Franchise Disclosure Document .................................................. 19
   (a) Item 6 (Other Fees) .................................................. 19
   (b) Item 8 (Restrictions on Sources of Products and Services) .................................................. 19
   (c) Item 9 (Franchisee’s Obligations) .................................................. 19
   (d) Item 11 (Franchisor’s Assistance, Advertising, Computer Systems, and Training) .................................................. 19

c. Creation of a Separate Legal Entity .................................................. 20

3. How to Implement a Gift Card Program (Operationally Speaking) .................................................. 21
   a. Third Party Vendors .................................................. 21
   b. Use of Advertising Funds .................................................. 21
   c. Gift Card Advisory Board .................................................. 22
   d. Changes to Operations Manual/Training for Franchisees .................................................. 23
   e. Gift Card Accounting Issues .................................................. 23
      i. Gift Card Revenue .................................................. 24
      ii. Use of Escrow Account .................................................. 24
      iii. Payment of Royalty Fees .................................................. 24
      iv. Dealing with Breakage .................................................. 25

III. LOYALTY PROGRAMS .................................................. 25

   A. Legal Framework .................................................. 26
      1. Generally not Regulated .................................................. 26
      2. Contract and Misrepresentation Claims .................................................. 27
      3. Privacy Issues .................................................. 32

   B. Implementation and Operations Issues .................................................. 32
      1. Franchise Agreements .................................................. 32
2. Program Materials and Disclosures .................................................. 34
3. Compensation for Customers’ Exercise of Rewards .................. 36
4. Advertising Fund Use ............................................................... 38
5. Record-Keeping .................................................................. 38
6. Overall Effectiveness ............................................................. 39

IV. CONCLUSION ................................................................................. 40
GIFT CARDS AND LOYALTY PROGRAMS IN FRANCHISE SYSTEMS

I. INTRODUCTION

Gift cards are increasingly common in franchise systems. They come with a variety of monikers, including “stored-value cards” and “prepaid cards,” and are the technological successor to their more primitive cousin, the paper-based gift certificate. Under any name, their purpose is to allow customers to pre-purchase the products or services of a business, and if they wish, to transfer the value of that purchase to others, usually as gifts, or to store that value for the purchaser’s future use.

This paper’s discussion of gift cards will focus on “closed-loop” cards, which are stored-value cards that can be used only at a single retailer or family of affiliated retailers.1 Closed-loop cards, because of the limits on where they can be used, are used by franchise systems to capture value in advance and to drive customers into their branded businesses.

As of the publication of this paper, twenty-seven of the top fifty franchise systems2 have established a gift card program that is regularly promoted by the franchisor. Gift cards are particularly common in the quick-service restaurant industry, which dominates the roster of major franchise systems.

Gift cards are governed by both federal and state governments, and this paper will examine the patchwork of laws and regulations that apply, and the interconnections between state and federal laws and between the laws of multiple regulating states. It will also examine the legal and practical implications of establishing and maintaining a gift card program in a franchise system, including the agreement provisions necessary to mandate or encourage gift card use and acceptance by franchisees, the logistical challenges to establishing and maintaining gift card programs, the financial risks that accompany gift card programs, and best practices for operating gift card programs successfully.

This paper will also examine loyalty programs in franchise systems. Like gift cards, loyalty programs go by a variety of names, including “rewards programs” and “frequency programs.” As used by the authors, a “loyalty program” is an ongoing promotional program that allocates points or uses another metric to recognize a customer’s frequency of use or purchases of that system’s products or services. The airline industry was an early adopter of this type of system through “frequent

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1“Open-loop” cards are typically issued by banks, and can be used at any retailer that accepts the associated card brand, such as American Express, Discover, MasterCard, or Visa.

flyer” programs. Franchisors, among other consumer-driven businesses, have increasingly rolled out similar programs to encourage repeat visits and purchases.

As of this paper’s publication, there are eighteen promoted loyalty programs now offered by the top fifty franchise systems. These are concentrated in the hotel industry, but are growing in popularity in the restaurant segment, among others.

Unlike gift card programs, loyalty programs are subject to little or no U.S. regulation other than the regulations that govern all advertising and promotional programs. Nevertheless, they can subject franchisors to contractual liability, because they constitute an agreement between the franchisor and customer by which the franchisor promises benefits in exchange for the customer’s purchases. Also, franchisors risk legal liability to their own franchisees if their agreements do not properly anticipate or account for loyalty programs. This paper will examine the legal risks associated with loyalty programs, and will discuss how to establish and maintain loyalty programs to minimize that risk, including logistical challenges and best practices.

II. GIFT CARDS

Gift cards are becoming increasingly popular in the United States, generating billions of dollars in revenue each year. For a franchise system, gift cards can be effective tools to generate not only revenue, but also consumer interest and brand awareness. The promise of more revenue and brand recognition, however, is accompanied by both federal and state regulations and practical considerations that, if ignored, could have expensive legal consequences and tarnish the franchise brand. The following sections examine the federal and state laws that apply to gift cards and address best practices for implementing and administering a gift card program.

A. Legal Framework

Several states have long recognized the need to regulate gift cards. Over thirty (30) states currently have gift card statutes many of which are inconsistent with each other. Adding to the landscape of gift card regulation is the recently passed

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3 Id. This does not include the numerous “insider” clubs that customers can join to get coupons and advance notice of promotions and new items, but that do not accumulate points from purchases or provide any benefit for repeat visits.

4 The development of gift cards and loyalty programs has been primarily an American phenomenon. Increasingly, however, businesses in foreign countries have begun to utilize such programs. Although this paper focuses on compliance issues surrounding the structuring of gift and loyalty card programs in the United States, franchisors wishing to implement gift card or loyalty programs internationally must first decide in which country or countries the gift card will be issued. Also, will the cards be country-specific or redeemable in several countries (possibly raising redemption issues)? In instances where specific gift card laws are not in place, a country’s general laws must be examined to determine proper compliance when establishing a gift card or loyalty program. Such general laws may include banking regulations, tax, privacy, data protection, fraud, money-laundering; and those relating to consumer protection.
Credit Card Accountability, Responsibility and Disclosure Act of 2009\(^5\) (the “Credit CARD Act”), which became effective August 22, 2010. Although the Credit CARD Act may be helpful in clarifying some issues related to administering a gift card program, various state laws and the inter-play between them make it difficult and confusing for businesses operating gift card programs in multiple states.

1. **Federal Regulation: The Credit CARD Act**

The Credit CARD Act is chiefly aimed at reforming credit card practices. It does, however, contain several provisions that all issuers of gift cards must consider when structuring their gift card programs. Title IV of the Credit CARD Act establishes threshold requirements for gift cards, with a focus on disclosure requirements and limits on expiration and fees.\(^6\) Title IV amends the Electronic Fund Transfer Act,\(^7\) previously largely inapplicable to gift cards. By its terms, Title IV of the Credit CARD Act will apply to “gift certificates,” “store gift cards,” and “general use prepaid cards,” as those terms are defined by the Act.\(^8\) The Credit CARD Act does not apply to prepaid cards received through a loyalty, award, or promotional program.\(^9\) Likewise, the Credit CARD Act will not apply to gift certificates issued in paper form.\(^10\)

a. **Disclosure Requirements**

Like all states that regulate gift cards, Title IV of the Credit CARD Act requires that gift card issuers disclose fees to gift card purchasers. The Credit CARD Act specifically requires that the gift card clearly and conspicuously state:


\(^8\) This article primarily addresses regulations governing “stored-value gift cards” (closed-loop gift cards), which are defined as:

[A]n electronic promise, plastic card, or other payment code or device that is –

(i) redeemable at a single merchant or an affiliated group of merchants that share the same name, mark, or logo;

(ii) issued in a specified amount, whether or not that amount may be increased in value or reloaded at the request of the holder;

(iii) purchased on a prepaid basis in exchange for payment; and

(iv) honored upon presentation by such single merchant or affiliated group of merchants for goods or services.

Credit Card Act at 1752.

\(^9\) Id.

\(^10\) Id.
that a dormancy, inactivity, or service fee may be charged;
• the amount of any dormancy, inactivity, or service fee;
• the frequency with which the fee may be assessed; and
• that such a fee may be assessed for inactivity.\textsuperscript{11}

b. \textbf{Expiration Provisions}

Gift card holders have often been surprised to learn that their gift cards have expired even though value remained on the card. Many gift card issuers, however, rely on expiration dates to help manage their gift card programs; allowing a gift card to remain viable indefinitely is not an attractive option for gift card issuers. The Credit CARD Act attempts to balance the concerns of both holders and issuers of gift cards. Specifically, the Credit CARD Act prohibits expiration of gift cards for at least five years from the date the card is purchased or from the date on which the gift card funds were last loaded onto the card.\textsuperscript{12} Moreover, it requires issuers who choose to impose an expiration date in compliance with the Act to disclose that date clearly and conspicuously.\textsuperscript{13}

c. \textbf{Fees}

As discussed above, the Credit CARD Act requires gift card issuers to disclose all fees. It also limits when dormancy, inactivity and service fees can be assessed. According to the Credit CARD Act, all dormancy, inactivity, and service fees are prohibited unless: (1) there has been at least one year (12 months) of inactivity on the gift card; (2) all disclosure requirements are met; and (3) no more than one fee per month is charged.\textsuperscript{14} Notably, each time the gift card is used, the 12-month inactivity or dormancy period required before fees can be changed restarts. The Act does not limit the amount of the permitted fees, however. In fact, consumer groups urged the Board of the Federal Reserve, the rulemaking entity, to impose a cap on the amount of permitted fees, as it has authority to do under the Act.\textsuperscript{15} The Board of the Federal Reserve elected not to do so.

\textsuperscript{11}Id. at 1753.
\textsuperscript{12}Id.
\textsuperscript{13}Id.
\textsuperscript{14}Id. at 1752-53.
d. **Effect on State Laws**

As more fully addressed below, state laws regulating gift cards will not in large part be affected by the Credit CARD Act. In fact, the Act specifically permits state laws that afford consumers greater protections than those afforded under the provisions of Title IV of the Credit CARD Act. In contrast, state law provisions offering more limited protections likely will be preempted by the new federal regulations.\(^{16}\) Because the Credit CARD Act will not preempt most state laws regulating gift cards, franchisors and other gift card issuers that operate in various states are still required to identify and implement the most restrictive regulations; otherwise, they run the risk of violating a specific state’s gift card statute.

2. **State Regulation**

Prior to enactment of the Credit CARD Act, the vast majority of regulations in place to address closed-loop gift card programs arose under various state laws. At present, the majority of states regulate some aspect of gift cards, whether it be disclosure requirements, use of service and other fees, legitimacy of expiration dates, or escheat. While some states provide only minimal regulation, others have very robust laws addressing virtually every aspect of gift cards.\(^{17}\)

a. **Disclosure Requirements**

The majority of state statutes regulating gift cards include baseline disclosure requirements that issuers of gift cards must satisfy prior to imposing any fee or expiration date. In general, these statutory provisions require conspicuous disclosure of essential terms either on the face of the card itself, on the sales receipt accompanying the card, or accessible through the Internet or a toll-free telephone number. For example, in Massachusetts, the date of gift card issuance and the date of expiration must be clearly printed on a sales receipt or otherwise made available to the purchaser through an Internet website or a toll free telephone number.\(^{18}\) Similarly, in Nevada, the expiration date or a toll-free telephone number that can be used to inquire as to the balance on the card and its expiration must be conspicuously disclosed.\(^{19}\)

Other states’ disclosure requirements are more specific and onerous. Oregon law, in the limited instances in which it permits expiration dates at all, requires that the gift card bear, in at least 10-point type, the words “EXPIRES ON” or “EXPIRATION DATE,” followed by the date on which the card expires.\(^{20}\)

\(^{16}\)Id. at 1754.


\(^{18}\)MASS. GEN. LAWS ANN. ch. 200A, § 5D (West 2004).

\(^{19}\)NEV. REV. STAT. ANN. § 598.0921(1)(a) (West 2009).

\(^{20}\)OR. REV. STAT. ANN. § 646A.278 (West 2003).
Arkansas permits post-sale fees, but only if the amounts of the fees are clearly and conspicuously placed on the front or back of the gift card in at least 10-point type with the circumstances under which each fee will be imposed, the frequency with which the fee will be imposed, and whether the fee is triggered by inactivity.21

Likewise, New York requires that retailers not only disclose the terms and conditions of gift cards on the card itself, but also on signage posted in the store where the gift card is sold. The “terms and conditions” that must be disclosed include: (a) the expiration date, (b) whether any fees are assessed against the balance of the gift card, and (c) whether a fee will be charged for the replacement of a gift card that is lost, stolen, or destroyed. 22

The extent of disclosure requirements varies significantly by state, and further disclosure provisions are addressed in the sections below that deal with expiration of gift cards and assessment of fees.

b. Expiration Dates

As of the date of this publication, thirty-five state laws include a provision governing the expiration of gift cards. Although the provisions vary by state, they can be categorized generally as one of three types: (1) those requiring conspicuous disclosure of the expiration date established by the issuer, without further restriction; (2) those mandating a specific duration of time during which the gift card remains valid and cannot expire; and (3) those that prohibit the use of expiration dates entirely.

In states like Arizona, Georgia, Nebraska, Nevada, New York, Texas, and Virginia, only conspicuous disclosure is required to impose a gift card expiration date, although the validity of any statutory provisions allowing gift cards to expire sooner than five years from the date of issuance or the date on which it is reloaded may be called into question after Title IV of the federal Credit CARD Act becomes effective on August 22, 2010. 23 Unlike this handful of states, the majority of states addressing gift card expiration impose minimum duration requirements ranging from one year to seven years. 24 Among the states are:

- Arkansas: at least two years from the date of issuance25

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21 ARK. STAT. ANN. § 4-88-703(a) (West 2004).
22 N.Y. GEN. BUS. LAW § 396-i (McKinney 1996).
23 Arizona, ARIZ. REV. STAT. ANN. § 44-7402 (West 2003); Georgia, GA. CODE ANN. § 10-1-393(b)(33)(A)(ii) (West 2003); Nebraska, NEB. REV. STAT. ANN. § 69-1305.03 (LexisNexis 2005); New York, N.Y. GEN. BUS. LAW § 396-i (McKinney 1996); Texas, TEX. BUS. & COM. CODE ANN. § 35.42 (Vernon 2002); Virginia, VA. CODE ANN. § 59.1-531 (West 2001).
24 Again, state statutory provisions mandating less than five years’ duration before expiration of a gift card are likely preempted by the Credit CARD Act.
25 ARK. CODE ANN. § 4-88-703(a), (c) (West 2004).
• *Hawaii*: greater than two years\(^{26}\)

• *Illinois*: effective January 1, 2008, at least five years after the date of issuance\(^{27}\)

• *Kentucky*: not less than one year from the date of issuance\(^{28}\)

• *Louisiana*: more than five years from the date of issuance\(^{29}\)

• *Massachusetts*: not less than seven years after its date of issuance\(^{30}\)

• *Michigan*: at least five years\(^{31}\)

• *New Jersey*: at least two years from the date of sale\(^{32}\)

• *Tennessee*: at least two years after issuance.\(^{33}\)

The last category of states, those that generally prohibit expiration of gift cards entirely, include California, Connecticut, Maine, Minnesota, Montana, and Rhode Island.\(^{34}\) These state provisions are the most consumer-friendly and allow the holder of a gift card to use the card in perpetuity.\(^{35}\)

c. **Fees**

At present, nearly forty states permit the value stored on closed-loop gift cards to be reduced through the assessment of fees, including service fees, dormancy fees, and issuance or reinstatement fees, as long as issuers comply with a variety of disclosure requirements and other limitations. These requirements vary widely by state, with some states mandating only disclosure of the fee amount and

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\(^{26}\) *HAW. REV. STAT. ANN.* § 481B-13 (West 2009).

\(^{27}\) *815 ILL. COMP. STAT. ANN.* § 505/2SS(b) (West 2008).

\(^{28}\) *KY. REV. STAT. ANN.* § 367.890 (West 2006).

\(^{29}\) *LA. REV. STAT. ANN.* § 51:1423(B)(1) (West 2003).

\(^{30}\) *MASS. GEN. LAWS ANN.* ch. 200A, § 5D (West 2004).

\(^{31}\) *MICH. COMP. LAWS ANN.* § 445.903g (West 2002).


\(^{33}\) *TENN. CODE ANN.* § 47-18-127 (West 2002).


\(^{35}\) The prohibition on gift card expiration dates does not necessarily mean that the gift card can be used in perpetuity. Fees can be assessed on the balance of the card until no balance remains. In *Freeman v. Wal-Mart Stores, Inc.*, 111 Cal. App. 4th 660 (Cal. Ct. App. 2003), the California appellate court confirmed that such a practice does not violate California’s prohibition on the sale of gift cards with expiration dates.
frequency with which the fee is assessed, and others prohibiting the assessment of service fees altogether. Between these two ends of the spectrum, the majority of states subject the assessment of fees to particular disclosure requirements and limitations as to the timing, frequency, and amount of the fee assessed. In Arkansas, for example, dormancy fees, inactivity charges, and other service fees are permitted, but only after two or more years from the date of issuance or sale of the card and only upon compliance with specific disclosure requirements. Similarly, New York law requires conspicuous disclosure of all service fees and restricts assessment of such fees until the thirteenth month after issuance of the gift card.

At least one New York court has addressed the applicable causes of action where a gift card issuer fails to disclose fees clearly and conspicuously, and where those fees are “excessive.” While many state statutes regulating gift cards do not include a private cause of action, Lonner v. Simon Prop. Group demonstrates that private citizens may nevertheless assert claims based on breach of contract and breach of implied covenant of good faith and fair dealing. In Lonner, the New York Court of Appeals found viable the plaintiffs’ breach of contract claims against the defendant for its failure to disclose properly a $2.50 dormancy fee charged against any amount remaining on the gift card after seven months. The court further held that the plaintiffs stated a claim for breach of implied covenant of good faith because they asserted that the dormancy fee was unreasonably excessive.

To avoid situations similar to that in Lonner, states like New Jersey, California, Oklahoma and Washington limit the amount of dormancy fees where those fees are permitted at all. For example, in New Jersey, dormancy fees cannot exceed $2.00 per month. Similarly, California, Oklahoma and Washington only permit dormancy fees of up to $1.00 per month on cards with a balance of $5.00 or less.

d. Escheat

“Escheat” is a technical term that refers to a reversion of property to the state under intestacy statutes when no rightful heir exists. State “escheat” laws have

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become increasingly important in the context of gift cards. According to one source, Americans spend approximately $65 billion on closed-loop gift cards annually, but fail to redeem $6.8 billion of the value of the purchased gift cards. This unredeemed value is often referred to as “breakage.”

State escheat laws generally fall into one of three categories: (1) those that explicitly exempt gift cards from the laws of escheat, or that do not address gift cards at all; (2) those that require partial reversion of unspent funds to the state (typically 60% of the remaining value); and (3) those that require reversion of the entire unused value of the gift card to the state.

Of these, the first category is clearly the most card issuer-friendly. So long as the gift card is not of perpetual duration based on state law prohibiting expiration of gift cards, the card issuer receives as income all value stored on the gift card as of the date of expiration, and the state never receives a portion of these funds. States falling into this category include Connecticut, Indiana, Maryland, New Jersey, Ohio, and Oregon.44

The second method, in which the unused funds partially revert to the state, is followed by states such as Maine, Montana, New Mexico, and North Carolina.45 Under this model, the issuer of the gift card must provide to the state a certain percentage (usually 60%) of the remaining value of the gift card upon expiration of the card, with the retailer permitted to retain the remaining value. That is, 60% of the gift card funds escheat to the state upon the card’s expiration.

The last category refers to states in which the escheat laws require reversion of the entire amount remaining on a gift card to the state upon its expiration. Examples of states currently falling into this category include Illinois, Nebraska, Pennsylvania, Texas, and Washington.46

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43According to research by TowerGroup, a financial consulting firm. See Erica Alini, Governments Grab Unused Gift Cards, WALL STREET J., June 30, 2009, at A3, available at http://online.wsj.com/article/SB124605742408663533.html#project%3DGIFT_MAP_0906%26articleTabs%3DArticle (with interactive map of state-by-state application to gift cards).

44See, e.g., Connecticut, CONN. GEN. STAT. ANN. § 3-73a (West 2007) (gift cards do not escheat to the state); Indiana, IND. CODE ANN. § 32-34-1-1 (West 2002); Maryland, MD. CODE ANN., COM. LAW § 17-101(m) (West 2009); New Jersey, N.J. STAT. ANN. § 46:30B-1 (West 2003) (gift cards not specifically included); Ohio, OHIO REV. CODE ANN. § 169.01(B)(2)(d) (West 2002) (gift cards exempted from unclaimed property fund); Oregon, OR. REV. STAT. ANN. § 98.302(8) (West 2003).

45Maine, ME. REV. STAT. ANN. tit. 33, § 1953(G) (1999) (60%); Montana, MONT. CODE ANN. § 70-9-803(g) (2009) (60% for gift cards redeemable for merchandise only and only when issuer sold more than $200,000 in gift cards in preceding fiscal year); New Mexico, N.M. STAT. ANN. § 7-8A-1(A)(7) (West 2003) (60% if redeemable for merchandise only); North Carolina, N.C. GEN. STAT. ANN. § 116B-53(c)(8) (West 2008) (only if card has an expiration date).

46Illinois, 765 ILL. COMP. STAT. ANN. § 1025/10.6 (West 2009) (only if expiration date or fees apply); Nebraska, NEB. REV. STAT. § 69-1305.03 (2005) (only if expiration date or fees apply); Pennsylvania, PA. CONS. STAT. ANN. tit. 72, § 1301.1 (West Supp. 2010) (only if expiration date or fees apply); Texas, TEX. PROP. CODE ANN. § 72.1016 (Vernon 2007); Washington, WASH. REV. CODE ANN. § 63.29.140 (West 2005) (only if expiration date or fees apply).
Within these categories, states vary with respect to the specificity with which escheat provisions apply to gift cards. The Alabama statute, for example, specifically exempts gift cards issued by “any person engaged primarily in the business of selling tangible personal property at retail.”\(^{47}\) For all other gift card issuers, the gift card is presumed abandoned three years after June 30 of the year in which the gift card is sold, but, if redeemable only for merchandise, only 60% of the gift card’s face value is abandoned.\(^{48}\)

In states subjecting gift cards to escheat, the duration of time before which the provisions apply varies by state and does not always coincide with the stated expiration date of the gift card. Some examples include:

- **Colorado**: five years for gift cards redeemable in cash\(^{49}\)
- **Delaware**: “the shorter of five years or the expiration period, if any, of the gift certificate less one day”\(^{50}\)
- **Georgia**: five years\(^{51}\)
- **Iowa**: three years\(^{52}\)
- **Louisiana**: three years after December 31st of the year it was sold\(^{53}\)
- **New York**: five years for all gift cards sold after December 31, 1983\(^{54}\)
- **Pennsylvania**: two years after the gift card’s redemption period has expired or five years from the date of issuance if no redemption period specified; gift cards that do not contain an expiration date and any type of post-sale charges or fees are explicitly exempted from escheat.\(^{55}\)

**Redemption for Cash Requirements**

Only a few states currently have specific statutory provisions addressing redemption of the remaining value of a gift card by the card holder where that value drops below a threshold amount, and consequently the majority of retailers require

\(^{47}\)AL. CODE § 35-12-73(b)(1) (Supp. 2009).
\(^{48}\)AL. CODE § 35-12-72(a)(17) (Supp. 2009).
\(^{49}\)COLO. REV. STAT. ANN. § 38-13-108.4 (West 2007).
\(^{50}\)DEL. CODE ANN. tit. 12, § 1198 (West 2006).
\(^{51}\)GA. CODE ANN. § 44-12-205 (West 2003).
\(^{52}\)IOWA CODE § 556.1 (West 2001).
\(^{54}\)N.Y. ABAND. PROP. LAW § 1315 (McKinney 1991).
\(^{55}\)PA. CONS. STAT. tit. 72, § 1301.1 (West Supp. 2010).
purchases at or above the full value of the gift card for the consumer to reap the full benefits of the card value. In October 2007, California passed a law amending Section 1749.5 of the Civil Code to “allow any gift certificate with a cash value of less than $10 to be redeemed in cash, as defined, for its cash value.” Among other states providing for similar refunds are Vermont and Massachusetts. In Vermont, if the remaining value of a gift card is below $1, the holder of the card may request a cash refund of this value. Moreover, following expiration of a gift card, the unused value of the gift card can be returned to the holder upon request. In Massachusetts, the holder of a gift card is permitted to receive the remaining balance of the gift card in cash if he so chooses, based on specific requirements as set out in the statute. For example, if the gift card is reloadable, the holder has the option to request a cash refund if the value of the card falls below $5.

f. Pending Legislation

In 2010 alone, over twenty states have introduced legislation involving various aspects of gift card regulation, including among them cash redemption, applicability of escheat, expiration dates, and post-sale fees. Taking a pro-consumer stance, California, Colorado, Illinois, Louisiana, Massachusetts, and Tennessee have pending legislation mandating that consumers be permitted to redeem the remaining value of a gift card for cash when that value drops below a specified dollar amount. Addressing fees and expiration dates, pending legislation in Missouri would prohibit the sale of gift cards containing any expiration dates or service fees of any kind, and would eliminate escheat provisions entirely. Similarly, several pending bills in New York propose to (1) prohibit the sale of gift cards that impose dormancy fees, surcharges, and other fees; (2) eliminate all expiration dates, except in very limited circumstances; and/or (3) require that gift cards be valid for a minimum of seven years prior to expiration and that the dates of issuance and expiration be printed on the gift card or receipt, or be available through the Internet or a toll-free telephone number. It is unclear which of the pending bills will pass into law, but at least some

57VT. STAT. ANN. tit. 8, ch. 81 § 2704 (West 2007).
58Id. at § 2702.
proposed legislation became moot on August 22, 2010, when the provisions of Title IV of the Credit CARD Act took effect.\(^{65}\)

3. **Inter-Jurisdiction Issues**

   a. **Relationship Between Federal and State Regulations**

   Under the Credit CARD Act, state laws are only affected or superseded “to the extent that those laws are inconsistent with the provisions of the Credit CARD Act, and then only to the extent of the inconsistency.”\(^{66}\) A state law is not inconsistent with the Credit CARD Act “if the protection such law affords any consumer is greater than the protection afforded by the Credit CARD Act.”\(^{67}\)

   In accordance with the Credit CARD Act, the Board of Governors of the Federal Reserve has the right to make the initial determination of whether a state law is inconsistent with, and therefore preempted by, the Credit CARD Act.\(^{68}\) Under the regulations associated with the Credit CARD Act, state law will be deemed inconsistent if it:

   - Requires or permits a practice or act prohibited by the federal law;
   - Provides for consumer liability for unauthorized electronic fund transfers that exceed the limits imposed by the federal law;
   - Allows longer time periods than the federal law for investigating and correcting alleged errors, or does not require the financial institution to credit the consumer’s account during an error investigation; or
   - Requires initial disclosures, periodic statements, or receipts that are different in content from those required by the federal law except to the extent that the disclosures relate to consumer rights granted by the state law and not by the federal law.\(^{69}\)


\(^{69}\) 12 C.F.R. Part 205.12(b)(2) (2010). This should be a familiar paradigm for franchise practitioners, as federal franchise law similarly allows states to add stricter protections for franchisees. And as with franchise law generally, this will inevitably generate questions about which is the stricter requirement, especially when the federal and state regulations do not lend themselves to apples-to-apples comparisons.
b. State vs. State Escheat

Under escheat rules, it is not always clear which state is entitled to the escheat of the customer’s funds in the gift card context. For example, the gift card may have been bought in one state and sent to a customer in another state, and that recipient may have reloaded it in yet another state (or multiple states); meanwhile, the franchisor who operates the gift card program may be incorporated in one state, headquartered in another state, and hold the funds in a third state (or use a subsidiary to manage the program and hold the funds, which adds another set of variables to the equation). In trying economic times, states have a compelling interest in being the recipient of escheat funds, and (as more funds are handled electronically) there are growing opportunities for funds to revert to state governments.

The seminal case on the rules of state priority for unclaimed funds was decided by the U.S. Supreme Court in 1965 in a dispute between the states of Texas and New Jersey. That decision first established the two central rules of priority. Under the first rule, a company holding unclaimed property must convey it, after the statutory time period has elapsed, to the state of the last known address of the apparent owner of that property, as reflected in the company records. Under the second rule, if the company does not have any record of the apparent owner’s address, or if those records indicate a home state that does not require escheat of unclaimed property, then the company must convey that property to the company’s state of incorporation.

By statute or court decision, the majority of states have established a third rule of priority in the event that the owner’s address is unknown (or that state does not require escheat) and the company’s own state of incorporation does not require escheat. This third rule requires escheat to the state in which “the transaction out of which the property arose occurred.”

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70 Which is especially common for holiday, birthday, and graduation gifts.

71 For example, the State of Washington’s Department of Revenue reports that, for its fiscal year 2008, it received over $100 million of unclaimed property, and that its annual receipts continue to grow. See ClaimYourCash.org, http://ucp.dor.wa.gov/aboutUCP.aspx (last visited Aug. 6, 2010).


73 Id. at 681-82. In the case of gift cards, there may be no way to determine whether the gift card is held by the original purchaser (who may provide identifying information to the franchisor) or by someone who received that card as a gift. Also unclear is how this first priority rule would apply in principle to a gift card that had originally been loaded with funds and given as a gift, but later reloaded by the recipient with his or her own funds.

74 Id. at 682. That is, assuming the company’s state of incorporation requires escheat.

In the franchise setting, it is likely that most escheated funds will transfer under the second rule, to the company’s state of incorporation. That is because most franchise-system gift cards are sold without recording the customer’s address, which most systems would find unreasonably burdensome to that transaction.\textsuperscript{76} If the funds rolled to the third rule of priority, the franchise setting complicates the already difficult question of where the “transaction . . . occurred.” A customer may purchase a gift card from a franchisee in one state, send it to a gift recipient in a second state, and that recipient may reload it at a franchised location in a third state; at the same time, the franchisor who administers the program may be incorporated in a fourth state, headquartered in a fifth state, have incorporated a subsidiary (perhaps in a state that does not require escheat) to administer the gift card program in a sixth state, and hold the funds at a financial institution in a seventh state. In that scenario, the transaction did not meaningfully arise in any single state. At best, the franchisor can only apply a consistent approach, and defend any challenge with the argument that no one state has a clear entitlement to those funds.\textsuperscript{77}

B. Implementation and Operations Issues

In general, a franchisor that is considering instituting a gift card program should consider the following:

- What benefits will a gift card program bring to my franchise system? Are there any drawbacks?

- What are the various costs of implementation of a gift card program to me as a franchisor and to my franchisees?

- How will I implement a gift card program? What changes will I need to make operationally (hardware, software, training), and what legal considerations should I anticipate (formation of a new entity, changes to manuals, changes to franchise agreements)?

- If I can, should I require that all franchisees participate in a gift card program?

- What do I need to do to ensure that proper accounting procedures for gift card sales and redemption are used?

These subjects, among others, are discussed below.

\textsuperscript{76}It is not clear whether the first rule of priority would be activated if the holder of unclaimed property had information that could lead to the owner’s address, but not the address itself. For instance, it may be possible (if not now, in the future) to derive a billing address—or at least a home state—from a credit card number used to purchase a gift card.

\textsuperscript{77}For an artful discussion of this and other related issues, see Phillip W. Bohl, Kathryn J. Bergstrom & Kevin J. Moran, \textit{Prepaid Cards and State Unclaimed Property Laws}, 27 Franchise L.J. 23 (2007).
1. **Deciding Whether to Implement a Gift Card Program**

When deciding whether to implement a gift card program for a particular franchise system, the franchisor must examine the characteristics of the particular franchise system. The gift card program must be cost-effective, and the franchisor should balance the potential benefits to the system with the prospective costs of implementation. Most often, gift card programs are profitable for franchise systems that provide low-cost, volume goods such as a retailer or a quick-service food provider. By contrast, if the franchise provides services at a higher cost (for example, a home nursing care service), the costs of implementation may outweigh the potential benefits.

a. **Costs of Implementation**

The franchisor will incur certain costs to implement a successful gift card program. A franchisor may hire a consultant to guide it through the implementation process. The franchisor must consider the design of the gift card, and choose a hardware/software provider to process the gift cards at the point-of-sale. The franchisor also must consider whether it will provide incentives to its franchisees to encourage participation (such as free cards, display cases, marketing materials, and hardware/software). Also, time and effort will be spent to determine how the program will be implemented – and changes will need to be made to the operations manual, and likely other documentation. Further, training on the state and federal regulation of gift cards should be required for the franchisor, and possibly for franchisees.

The franchisor must consider the costs to the franchisee as well. If the cost to the franchisee is too high, the percentage of participation will be low, and/or objections from the franchisees may be heard. Costs to the franchisee could include the cost of new hardware, software, additional training expenses, and gift card supplies (i.e., the actual gift cards, display cases, etc.).

b. **Benefits of Implementation**

A gift card program can be quite lucrative for the franchisor. Ideally, it will boost sales for all who sell and redeem cards, thereby increasing profits to franchisees and royalty flow to the franchisor. Increased brand recognition and the extra revenue can stem from sales to those who enjoy the convenience of a card (as opposed to using cash), from those who provide gifts to others, from those who “reload” previously sold gift cards, and from those who “empty” the gift card and then make up the difference in the purchase price with cash or a credit card supplement. Revenue can also come to the system through third-party sales of gift cards such as sales by distributors (e.g., such as Incom Direct or Blackhawk Network’s “Gift Card Mall,” companies which make gift cards widely available in drug and grocery stores). Another source of revenue are “B2B” (business to business) sales, whereby gift
cards are sold to large corporations, charities, school groups and others as part of employee incentive programs, fundraising programs and the like.

In the United States, as indicated above, approximately $6.8 billion in gift card dollars go unredeemed annually. Often, this breakage will enter back into the franchise system. Depending on how the gift card program is structured, and assuming applicable state escheat laws would permit it, the breakage may return to the franchise system in the form of a contribution to an advertising fund, or as income to the franchisor. Alternatively, some franchisors have distributed breakage amounts back to the franchisees, either as a “rebate” to franchisees who have sold gift cards (for example, the return of five percent (5%) of the value of the gift cards sold by franchisees), or, as a periodic distribution to all franchisees in the system. This subject is further discussed in Section 3(e)(4), below.

2. How to Implement a Gift Card Program (Legally Speaking)

Certain legal issues arise when considering the implementation of a gift card program. For example, the franchisor must determine whether to make participation in a gift card program mandatory or voluntary. If mandatory participation in the gift card program is the goal, then the franchisor must ascertain the legal basis on which it might be able to do so. If the program is voluntary, the franchisor should consider the potential pitfalls of voluntary participation, including confusion (and frustration) by customers – imagine a customer who receives a gift card, but is unable to redeem the gift card at all locations due to non-participation by some franchisees. Such non-participation would result in inconsistency across franchised stores, an unwanted characteristic of a franchise system. This potential confusion could be the reason that most franchise systems require, whenever possible, participation by all in gift card programs.79

a. Current Franchisees

As mentioned above, most franchisors would like to have mandatory participation in their gift card programs. For current franchisees, especially those with older forms of franchise agreements, it is probable that their franchise agreements do not specifically state that the franchisee must participate in a “gift card program.” Instead, the “hook” will need to be found in the form of a requirement to participate in marketing programs, “as designated by the franchisor in the manual or otherwise in writing.” Alternatively, the franchisor can look to provisions that require the franchisee to adhere to all systems and procedures set

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78 See Alini, supra note 41, at 9.
79Full participation is often rolled out on a region by region basis, or perhaps on the basis of those who upgrade to necessary hardware and software systems. It is possible for a franchisor to require that all franchisees accept gift cards as payment (while not requiring the sale of such cards). Also, even in systems that require mandatory participation, there could be exceptions, such as seasonal locations, locations that do not have compatible POS devices, locations in venues where gift cards would not likely be present (e.g., on cruise ships), etc.
forth in the manuals. Assuming such a “marketing” provision, or at least a “manual” provision, the franchisor can seek mandatory participation through a change to the operations manual. However, there are limits regarding what the franchisor can seek to achieve through operating manual changes. For example, fundamental changes that are not clear in the franchise agreement, are costly, and are beyond the reasonable scope of the parties at the time they entered into the franchise agreement, could be found to violate the covenant of good faith and fair dealing. Thus, the franchisor faced with this situation will want to find not only the strongest language that exists to support mandatory implementation of the gift card program, but also to implement the program in the least costly and objectionable manner for franchisees.

b. **Prospective Franchisees**

Implementing a gift card program on a going-forward basis provides the franchisor with an opportunity to clarify the franchise system’s gift card program and participation expectations, through additions to the franchisor’s franchise agreement and franchise disclosure document (“FDD”).

i. **Franchise Agreement**

As mentioned above, modern franchise agreements will often contain a clause requiring the franchisee to participate in advertising programs and promotional events as directed by the franchisor, outside of any required advertising fund(s). While this broad language will permit the franchisor to require participation by the franchisee in a variety of programs, it is wise to add a provision that relates to the franchisor’s specific gift card program. An example of such a provision is:

Franchisee shall participate in promotional programs developed by Franchisor for the System, in the manner directed by Franchisor in the Manual or otherwise in writing. Additionally, Franchisee shall sell or otherwise issue gift cards (“Gift Cards”) that have been prepared utilizing the standard form of Gift Card provided or designated by Franchisor, and only in the manner specified by Franchisor in the Manual or otherwise in writing. Franchisee shall fully honor all Gift Cards that are in the form provided or approved by Franchisor regardless of whether a Gift Card was issued directly or indirectly by Franchisee, Franchisor or another franchisee. Franchisee shall sell, issue, and redeem Gift Cards in accordance with procedures and policies specified by Franchisor in the Manual or otherwise in writing, including those relating to

80 See, e.g., *Bird Hotel Corp. v. Super 8 Motels, Inc.*, No. Civ 06-4073, 2010 WL 573741 (D.S.D. Feb 16, 2010) (finding a breach of contract when the franchisor required franchisees to pay increased fees for participating in a customer loyalty program, where the franchise agreement did not reserve the right to unilaterally modify such fees).
procedures by which Franchisee shall make timely payments to Franchisor or its designee for Gift Cards sold by Franchisee and shall request and receive reimbursement from Franchisor or its designee for goods and services sold in exchange for Gift Cards issued directly or indirectly by Franchisee, Franchisor, or another franchisee.

This provision not only makes clear that the franchisor is requiring the franchisee to participate in the gift card program (both selling and redeeming cards), but it also gives the franchisor “wiggle room” to tailor the gift card program in the future through the use of the operating manual or other written form of communication.

If the implementation of a gift card program will require a computer system that has the ability to process gift cards properly, the franchisor may wish to include such a provision in the franchise agreement as well. For example:

Franchisee shall purchase or lease, and install, all required fixtures, furniture, furnishings, signs and equipment (including required computer, point-of-sale, and other electronic information systems and all equipment components and software necessary for you to accept and process our gift cards [and loyalty cards] and participate in our gift card, [customer loyalty,] and similar programs) for the location.

Revenue derived from gift card sales is not typically included in the franchisee’s gross sales. However, gift card values that are redeemed for goods or services sold are typically considered to be gross sales, upon which a royalty must be paid. Thus, the franchisor may wish to include within its definition of “gross sales” a statement similar to the following:

As used in this Agreement, the term “Gross Sales” means all revenue that you derive from operating the franchise location . . . but excludes revenue you derive from selling or issuing system gift or loyalty cards (although revenue you derive from selling Products to customers who use such cards for payment will be included in Gross Sales).

As discussed in Section B.3.(c) below, the role that revenue derived from gift card sales plays in a franchisee’s gross sales may be a complex issue. If, for example, incentives are given to franchisees in the form of a percentage of gift card amounts sold, an issue arises as to whether the franchisee should pay royalties on such incentive payments.
ii. Franchise Disclosure Document

Although not specifically required by the FTC Rule,\textsuperscript{81} to ensure full disclosure of the franchisor’s gift card program, the gift card requirements and provisions should typically appear in the FDD within the following items: Item 6 (Other Fees), Item 8 (Restrictions on Sources of Products and Services), Item 9 (Franchisee’s Obligations), and Item 11 (Franchisor’s Assistance, Advertising, Computer Systems, and Training).

(a) Item 6 (Other Fees)

Item 6 of the FDD contains a description of the royalty payable to the franchisor, which is typically a percentage of gross sales. The definition of “gross sales” usually appears in the fourth column (“Remarks”). It is appropriate to note in the Remarks column that a definition of “gross sales” excludes revenue derived from selling or issuing gift cards; however revenue derived from the redeeming of such cards (where the product or service is given in return) must be included in gross sales.

(b) Item 8 (Restrictions on Sources of Products and Services)

Item 8 of the FDD contains disclosure with regard to the franchisee’s obligations to purchase. In the context of a gift card program, such requirements would include the computer hardware and software necessary to accept and process gift cards. Normally, the franchisor chooses one company as the sole supplier of gift card processing services, and this fact should be mentioned in this item. If the franchisor receives any rebates from the gift card processor from the purchase of the gift card hardware or software, or from the fees paid for processing, such rebates also must be disclosed in this item.

(c) Item 9 (Franchisee’s Obligations)

The franchisee’s obligation to participate in a gift card program should be noted in Item 9, along with the sections of the Franchise Agreement and FDD that discuss such obligations.

(d) Item 11 (Franchisor’s Assistance, Advertising, Computer Systems, and Training)

Item 11 should contain disclosure of franchisor’s requirements to purchase a computer system. As gift card hardware and software typically is integrated into the franchisee’s overall computer system, the following (which could be in the context of the overall computer system) would ordinarily be disclosed:

\textsuperscript{81}FTC Trade Regulation Rule, 16 C.F.R. § 436 (2007) (the “FTC Rule” (“Disclosure Requirements and Prohibitions Concerning Franchising”).
• A description of the required gift card hardware and software
• Cost of purchasing or leasing such a gift card system
• Any obligation of the franchisor, affiliate or third party to provide ongoing maintenance or repairs
• Any obligation of the franchisee to upgrade or update the gift card system (including the frequency and cost of such obligation)
• The annual cost of both optional and required maintenance, updating, upgrading, or support contracts
• Whether the franchisor will have independent access to the information contained in the computer system. If so, the types of accessible information must be described, and if any limitations have been placed on the franchisor’s right to access the information, such limitations would typically be described.

Note that independent access to gift card information is crucial to the proper implementation of the gift card program. Ideally, the franchisor can access a particular store’s gift card purchases and redemptions at any point in time, allowing for reconciliation of the franchisee’s account. In particular, if the franchisee wishes to partake in any kind of incentive program based on gift card sales, access to accounting records for gift cards sales is essential.

c. **Creation of a Separate Legal Entity**

The franchisor may also wish to consider the creation of a separate legal entity for the funding and management of the gift card program. Initially, this entity may be funded by the franchisor, in order to fund start-up costs relating to the program, such as design costs, training, and the provision of other incentives to the franchisees (such as equipment, etc.). Then, the entity could be funded by the anticipated breakage amounts. Franchisors that form such an entity are more easily able to keep separate the gift card funds from its usual operational and marketing accounts. The franchisor also may wish to form this entity in a state where the escheat laws are favorable to gift cards.\(^\text{82}\)

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\(^{82}\) As discussed in more detail in Section II.A.2(d) of this paper, the unclaimed gift card funds do not escheat to the state in Connecticut, Indiana, Maryland, Ohio and Oregon. See Connecticut, **CONN. GEN. STAT. ANN. § 3-73a** (West 2007) (gift cards do not escheat to the state); Indiana, **IND. CODE ANN. § 32-34-1-1** (West 2002); Maryland, **MD. CODE ANN., COM. LAW § 17-101(m)** (West 2009); Ohio, **OHIO REV. CODE ANN. § 169.01(B)(2)(d)** (West 2002) (gift cards exempted from unclaimed property fund); Oregon, **OR. REV. STAT. ANN. § 98.302(8)** (West 2003).
3. **How to Implement a Gift Card Program (Operationally Speaking)**

Besides the legal considerations associated with the creation of a gift card program, the franchisor must consider the nuts and bolts of how the program will be implemented throughout the franchise system. Such issues include the choosing of a third party hardware or software provider, training of franchisees, changes to the manual, accounting procedures, and franchise relationship activities (such as the possible creation of a “gift card counsel” or franchise advisory committee to address the concerns of the franchisees).

a. **Third Party Vendors**

Third parties (such as Franchise Payment Network, Paytronix and First Data Prepaid Services) typically provide the hardware and software used to process gift cards. Ideally, the franchisee’s POS System will be able to activate, reload, redeem, check balances of gift cards, and print the remaining balance of the gift card on the receipt. Also, the POS System should be able to accept and process all types of gift cards offered by the franchise, if multiple card types are available. Some third party vendors offer web-based systems, while others offer add-on programs that work in conjunction with non-web-based POS systems.

The franchisor will need to enter into an agreement with the chosen third party vendor. The franchisor (or the separate entity that has been formed specifically for the gift card process) may be able to negotiate certain aspects of its relationship with the gift card processing vendor. The cost of such systems can vary. Perhaps large volume discounts on hardware or software are available. Or, the franchisor may be able to negotiate the rate of the processing fee that is normally charged on a per-transaction basis.

If the franchise system is one that anticipates a large volume of gift card sales, the income from such sales may soon outweigh the costs of the improved POS system. In addition, when first implementing a gift card program, the franchisor may wish to provide or supplement the costs of hardware and/or software to offset initial costs to the franchisee.

b. **Use of Advertising Funds**

The use of gift cards as a marketing tool should not be overlooked. One issue that must be determined is whether the use of gift cards can be deemed “advertising.” If so, should advertising funds contributed by franchisees be used to develop a gift card program? As gift cards can be considered to enhance the brand, the costs of a gift card program may constitute “advertising” or “marketing” expenditures that can be properly be paid for by the advertising fund.

Often, as indicated above, the franchisor funds the initial development of the gift card program. These “start-up” costs, which include the design of the cards, the
vetting of a third party vendor, and the choice of hardware and software, are usually
developed (and funded by) the franchisor. In addition, the franchisor may offer
additional incentives to the franchisees to encourage participation in the gift card
program (e.g., providing hardware and software at no cost to the franchisee).

When determining whether cash from an established advertising fund may be
used to pay for these initial expenses, the franchisor should consider possible
objections by franchisees to such use of these funds. Factors to be considered are
whether all franchisees will benefit from a gift card program, whether the franchisor
estimates a high level of breakage, and whether breakage may ultimately be
returned to the advertising fund. If a high level of breakage is expected, and these
funds will be returned to the advertising fund, it may be easier to convince
franchisees to allocate advertising funds to the establishment of a gift card program.

These same considerations should be made if the franchisor wishes to use
advertising funds to establish additional marketing programs that utilize gift cards.
These programs commonly require a third party vendor (who may be distinct from
the gift card processor), and may include making gift cards available in drug or
grocery stores, or developing a “B2B” program. When considering these types of
marketing programs, the franchisor might also wish to determine whether the effect
of such advertising will have a national, regional or local impact. In the case of drug
or grocery store sales of gift cards, most often the cards are sold on a national basis.
These cards would have the potential to be redeemed at various locations in many
territories. For a “B2B” program, in which gift cards are marketed to local or national
businesses to be used as corporate gifts, incentives, or for the business’s own
marketing use, the sale of gift cards (and their redemption) may be concentrated in a
specific region or city in which the business is located.

Given the choice, franchisees may wish to spend their “local marketing” funds
for the purchase of additional gift cards. For example, a franchisee may sell gift
cards to a local Boy Scout troop, with the hope that the local troop will come to his or
her outlet to redeem such cards with the potential for not just marketing advantages,
but also with the hope for added sales, or “upsale potential.” (As an example, if the
value of the gift card is $1.00, while the average sale is $3.00, the upsale potential is
$2.00.)

c.  Gift Card Advisory Board

Certain franchisors have established gift card advisory boards, similar in
nature to a franchisee advisory committee for a marketing fund. This type of
organization, comprised of franchisee and corporate members, could serve several
functions: (1) to be part of the development of the gift card program; (2) to oversee
the gift card funds, akin to having an audit function; and (3) to decide on matters
such as the means of breakage distribution.

Using advertising funds without the consultation and approval of a franchisee
advisory committee could be harmful to franchisor/franchisee relationships. Prior to
use of advertising funds, the franchisor would want to consult with the committee for
input and/or approval.
d. **Changes to Operations Manual/Training for Franchisees**

The franchise operations manual should contain guidelines for the implementation of the gift card program. The franchisor should consider including within the manual provisions such as the following:

- Full description of the gift cards that should be accepted by the franchisee, including the indicia on the card of system participation
- POS System requirements (e.g., issuance of cards, ability to check card balances, customer account history)\(^{83}\)
- Product Restrictions, if any (for example, in an instance where the franchisee sells both non-brand and brand products and the gift card is required to be redeemed only for brand items)
- Replacement card policy and procedure (for example, if card is rendered ineffective by the magnetic strip being damaged)
- Minimum card load amounts for activation
- Policy with regard to lost or stolen gift cards
- Description of franchisor support to franchisees throughout implementation of the program
- Instructions with regard to ordering new card supplies
- Policy with regard to changes to gift card system (notice of change to franchisee, if change optional or mandatory, timeline, cost of change)

**Gift Card Accounting Issues**

The accounting issues surrounding gift cards can be quite complicated, as the franchisor must take into consideration how revenue from the sale and redemption of the cards is calculated. Additionally, the franchisor must determine the manner in which the breakage will be distributed, used or retained in the event gift cards are not redeemed.

\(^{83}\)It is uncommon for gift card issuers to record personal identifying information of gift card purchasers or the intended recipient of the gift card. Rather, gift card issuers generally track the card based on the card number rather than who purchased the card. If, however, personal identifying information is collected by a franchisor, the franchisor must address various privacy issues. An introduction to these privacy issues, which apply equally to loyalty programs and gift cards if personal information is collected, is addressed at Section III.A.3 of this paper.
i. **Gift Card Revenue**

As discussed above, gift card revenue typically accrues when the gift card is redeemed and not when the gift card is sold. The franchisee must understand this, and measures must be in place to ensure that all accounting records are accurate.

Example: A gift card is sold by Store A for $100. Store A does not count this sale as gross revenue. The third party gift card administrator will keep track of this sale. The funds received from this sale will be transferred to an escrow or other separate account. Store B redeems this gift card for $80 in merchandise. Store B records this transaction as a sale, and has a gross revenue of $80, on which royalties must be paid.

The third party vendors of gift card hardware and software often incorporate the ability to create a daily, monthly or yearly report with regard to gift cards sold or redeemed by location. The franchisor (depending on the communications and ability to access the franchisee’s accounting systems) should have the ability to access this information as well in order to reconcile the franchisee’s accounts and the third-party vendor’s accounts relating to gift card sales. Often, franchisors will request that the third-party vendor reconcile the accounts on a weekly or monthly basis, and will calculate the “net gift card sales” for its franchisees.

Example: Store A sells $100 in gift cards in one week. In the same week, Store A redeems gift cards in the amount of $80. At the end of the week, $20 is pulled from the franchisee’s account and put into the common pool of funds (either in an escrow or separate entity’s account).

ii. **Use of Escrow Account**

As mentioned above, typically, gift card funds are kept in a separate escrow account. Also, a franchisor may establish a separate legal entity that will have control, typically through a separate account, over the gift card funds. In both cases, funds received from the sale of a gift card have a “holding place,” pending the redemption of a gift card. Also, the breakage has a safe harbor until a method of final distribution is put into place.

iii. **Payment of Royalty Fees**

When the gift card is redeemed and a gift card is used to purchase the item(s), revenue is generated by the sale and typically triggers the payment of royalty fees. The franchisor must also consider if royalty fees will be required on any additional amounts paid to the franchisee, for example, in the form of incentive rebates and on returned breakage.
iv. Dealing with Breakage

As discussed above, breakage is the revenue from sales of gift cards that goes unredeemed. Deciding what to do with the breakage amounts is an important decision for the franchisor, as the breakage amounts could be quite significant.

Before deciding what to do with breakage generated from a franchise system’s gift card sales, the franchisor should first determine when breakage can be calculated. That is, at what point will an unused amount be designated as breakage? Two years after the sale of the card? Three years? Some franchisors decide to use a percentage of all gift card sales to determine breakage (for example, two or three percent of all sales of gift cards will be deemed as breakage).

Whether the franchisor uses an escrow account or a separate entity to account for gift card funds, adequate funds must be retained so that the franchisee may be properly reimbursed from the account or fund for gift card redemption purchases. After this amount is determined, and the breakage amount is calculated – and assuming no escheat -- the franchisor has several options to deal with breakage.

The franchisor could consider the following options:

- Return the funds to the franchisee in proportion to the amount of gift cards sold as an incentive to sell additional gift cards.
- Distribute the breakage to franchisees in equal shares (perhaps to use for local marketing).
- As an alternative means for using breakage in the system and effectively returning it to franchisees, categorize the breakage as “marketing” funds and transfer breakage to the marketing or advertising fund, to be used for other marketing activities on behalf of the system.
- Keep the funds as a reimbursement to the franchisor for its costs of establishing the gift card program.

No matter which option the franchisor chooses, it must make sure that it complies with the federal and state rules with regard to proper franchise disclosure and state gift card escheat requirements.

III. LOYALTY PROGRAMS

Loyalty programs are an increasingly popular means of encouraging repeat customers and long-term loyalty to a brand or product. Loyalty programs are nothing new; the secret decoders of the 1930’s were given away by radio programs in conjunction with the purchase of their sponsor’s product, and listeners could then
use the decoder to translate secret message sent over the broadcast, encouraging further listening and exposure to sponsor messages. Today, communications technology has made loyalty programs more powerful, because a consumer’s purchases can be tallied and tracked across the globe, and perks and rewards can be delivered instantly. Today, loyalty programs are a routine part of the customer interaction with grocery stores, airlines, and a growing group of other retail industries.

In franchised industries, loyalty programs are ubiquitous in hotels, and are growing in popularity in restaurant chains. The following sections examine the legal framework in which franchise loyalty programs exist, the pitfalls that accompany loyalty programs, and best practices for instituting and administering loyalty programs in franchise systems.

A. Legal Framework

Loyalty programs are not heavily regulated, but they nonetheless create the potential for legal claims, and the information gathered to operate a loyalty program creates privacy issues that franchisors must manage.

1. Generally not Regulated

Unlike gift card programs, loyalty (or rewards) programs are generally unregulated. The new federal gift card regulations do not encompass loyalty programs, other than exemptions from certain requirements for gift cards issued as rewards for loyalty program members, including exemptions from certain provisions relating to dormancy fees, inactivity charges, and service fees. A number of states mirror the federal approach, exempting gift cards issued under loyalty programs from prohibitions on fees and charges.

One early effort at providing regulatory guidance for loyalty programs came from the National Association of Attorneys General, which issued a set of guidelines in 1988 for airline industry marketing practices, including for frequent flyer programs. Those guidelines did not have controlling legal effect, but have been cited by various courts to establish an airline’s reasonable basis for certain provisions in frequent flyer program terms and conditions, including terms allowing revisions that retroactively affect the value of accrued points. The introduction to the guidelines explains the attorneys’ general rationale, which is a telling backstory for any system considering a loyalty program:

84 12 C.F.R. Part 205.20(a)(4), (b)(3) (2010). However, disclosure requirements still apply to that type of gift card, including for the expiration date, the fees imposed, and how to obtain additional information on applicable fees. 12 C.F.R. Part 205.20(a)(4)(iii) (2010).

Frequent flyer programs have been widely acknowledged as the most successful marketing programs in airline industry history. The bargain struck between customers and the airlines has proven to be very costly to many of the airlines. Customers who have accrued the necessary mileage are expecting to collect the awards which led them to join and fly in the programs in the first place. Some airlines are now disturbed by the cost of keeping their side of the bargain and the real possibility that they may lose revenue because passengers flying on frequent flyer awards may begin displacing paying customers. The solution contemplated by some carriers has been to raise award thresholds and implement restrictions to decrease the cost to them of the award program. The effect of these actual and/or potential changes is to significantly devalue vested members’ accrued mileage or other credits in the program. Although various frequent flyer program awards materials have contained some obscure mention of the possibility of future program changes, these disclosures have been wholly inadequate to inform program members of the potentially major negative changes which are contemplated by many airlines.86

In sum, the NAAG Guidelines included the following recommendations to govern the conduct of airlines with frequent flyer programs87:

- Clearly disclose any limits on the availability of awards.
- If the requested award (flight) was unavailable, allow the customer to accept a reasonably close alternative award.
- Provide reasonable notice of changes to or termination of the program, with one year being established as the baseline reasonable notice period. Alternatively, “vested” members may be credited with additional points or units to compensate for the differences imposed following program changes.
- Provide clear notice of any reservation of the right to revise the program if the airline did not intend to notify members of changes at least one year in advance of the effectiveness of those changes.88

86 The original guidelines are available in an appendix to the Supreme Court’s decision in Morales v. Trans World Airlines, Inc., 504 U.S. 374 (1992). For the above quote, see id. at 407.
87 Id. at 407-17.
88 The NAAG Guidelines deemed the following versions of advance notice sufficient: (1) “(Airline) reserves the right to terminate the program with six months notice. This means that regardless of the amount you participate in this
• Any certificates, coupons, or vouchers issued to redeeming members should be valid for a reasonable period of time (with a one-year baseline for reasonableness), and should include a conspicuous disclosure of any restrictions on use.

• All terms and conditions should be disclosed prior to accepting any fee for enrollment.

While not conceived for franchise system loyalty programs, these NAAG Guidelines continue to provide useful guidance for franchisors, and indicate the primary issues that could prompt regulatory oversight or investigations in the future: inadequate disclosure of terms and conditions; lack of advance notice of changes; and, upon any changes, lack of reasonable accommodation for “vested” members, or at least reasonable notice.

2. **Contract and Misrepresentation Claims**

Loyalty programs have only infrequently been the subject of reported court decisions, and even more rarely have those come in the franchise context. The most cited cases come out of the airline industry, relating to frequent flyer programs, but they would provide persuasive guidance to any court hearing a franchise-related action.

In 1988, a group of American Airlines passengers filed a class action against the airline after American altered its benefits structure, including as it applied to accrued miles. The plaintiffs asserted claims for breach of contract and breach of Illinois's Consumer Fraud and Deceptive Business Practices Act. The case quickly ascended the appellate ladder after an interlocutory appeal was granted to resolve the question of whether federal airline regulations pre-empted the state law claims, a question eventually resolved by the U.S. Supreme Court. 89 In an earlier opinion addressing the contract claims, the Illinois Supreme Court had held that a customer earning frequent flyer miles formed a contractual relationship “which vests the frequent flyer with the right to earn specific travel awards.” 90


90 *Wolens v. Am. Airlines, Inc.*, 626 N.E.2d 206, 208 (Ill. 1993), aff'd in part, rev'd in part, 513 U.S. 219 (1995). It is unclear the extent to which the state court’s sentiment is dicta, because the opinion nominally was limited to whether those contract claims were pre-empted by federal law. The merits of those claims had not yet been resolved by the trial court.
altering the terms of its frequent flyer program, the airline had breached its contract and given rise to a damages claim by its customers.

Similar claims were asserted in a suit brought in 1995 by a group of USAir customers. The plaintiff group objected to the airline’s increase in the number of miles customers must redeem in order to obtain free domestic tickets. The airline applied its new standard to both future miles and previously accrued miles, but did give one year’s notice of the new awards standards and allowed redemptions under the prior standards during the interim period. The airline had disclosed its reservation of rights to adjust award levels in each iteration of its program materials, which included statements such as “with notice, USAir may raise award or mileage levels” and “mileage levels are subject to change with or without prior notice.” The airline also reserved the unlimited right to terminate the program at any time. The court held that the airline’s reservation of rights was clear and unambiguous, and gave the airline the right to modify its loyalty program, including as to miles previously accumulated. The court found particularly significant the airline’s reserved right to terminate the program altogether. If the airline had the right to eliminate entirely the value of customers’ accrued miles, the court reasoned, then surely it also had the right to modify or limit the value of those miles in lesser ways.

The Supreme Court of Alaska applied a similar analysis in a claim brought in 2002 against Alaska Airlines. Alaska’s terms and conditions included the statements: “Alaska Airlines reserves the right to change the Mileage Plan terms, conditions, partners, mileage credits and/or award levels. This means with prior notice Alaska Airlines may raise award levels or lower mileage levels . . . . Alaska Airlines reserves the right to terminate the Mileage Plan with advance notice. . . . Accrued mileage and award certificates do not constitute property of the member.” In March 2001, mileage plan members received a notification that the program would change its award levels effective September 1, 2001. The plaintiff’s claims, asserted on a class basis, included breach of contract, breach of the implied covenant of good faith and fair dealing, unconscionability, and conversion.

The trial court granted summary judgment in Alaska Airlines’ favor, and the Alaska Supreme Court affirmed, despite the absence of any terms and conditions

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92 Id at 431.
93 The court added an interesting policy note to its decision, finding that “[i]f plaintiffs’ interpretation were to govern, frequent flyer programs such as this would be impossible to administer. Essentially, it would be impossible to change the terms of the [program] because of the attendant problems that such changes would create in administering the program.” Id at 432. Unresolved was the question of whether those policy grounds would still prevail in the absence of a clear reservation of rights to change the program’s terms and conditions.
95 Id. at 658 (emphasis in original).
96 Though, prior to the action going up on appeal, the plaintiff had limited his complaint to a breach of contract claim only. Id. at 658.
specifically allowing the airline to modify awards for miles already accrued. The
court held that the overall intent of the program rules indicated that the airline had
that right, citing the disclosures that accrued miles did not constitute property of the
member, and that the airline had the right to terminate the program altogether.
Together, those indicated a clear intent to allow changes to the awards levels. As
with the court in Grossman, the Alaska court also noted the potential administrative
burden to the airline (as well as its customers) if it were obligated to track not only
the number of miles accrued, but when those miles were accrued and what awards
levels were in place at the time.97 Finally, the court held that earlier changes made
by the airline, and the absence of any objection by the plaintiff, amounted to the
plaintiff’s assent to the airline’s right to make additional changes, including the
changes that formed the basis of the lawsuit.98

A more whimsical take on loyalty programs comes from a lawsuit brought
against Pepsi based on its “Pepsi Points” program introduced in the 1990’s. Pepsi
offered its customers the opportunity to redeem points earned by buying Pepsi
products for branded apparel and other prizes. Pepsi’s promotion of the program
included a television commercial that showed a series of available rewards and the
points that corresponded to each: a t-shirt for 75 points, a leather jacket for 1,450
points, and an intended joke, an AV-8 Harrier II fighter jet for 7,000,000 points.99
Unfortunately for Pepsi, it had devised its program to allow customers to purchase
points for 10 cents each, and a customer sent the company a certified check for
$700,000 to purchase the necessary points to obtain the jet. When Pepsi rejected
the check and refused to provide the prize, the customer sued. The court ruled in
favor of Pepsi, finding that the advertisement did not constitute an offer, that no
reasonable person would believe that the company would make such an offer, and
that any would-be agreement between Pepsi and the customer failed to meet the
requirements under the Statute of Frauds.100

In the franchise context, loyalty programs have been the subject of a claim by
a franchisee against the franchisor, based on the franchisor’s alleged lack of

97Id. at 663.
98Id. at 664.
99The “retail” price of the jet at that time was around $23 million. Leonard v. Pepsico, Inc., 88 F. Supp. 2d 116, 129
(S.D.N.Y. 1999), aff’d, 210 F.3d 88 (2d Cir. 2000).
100Id. While the claim itself is hard to take seriously, the court’s rationale in dismissing it may not have been entirely
sound. The court’s primary grounds was that the advertisements were not an offer, but only an invitation to enter into
negotiations, and did not constitute a “reward” offer: “[T]he Harrier Jet commercial did not direct that anyone who
appeared at Pepsi headquarters with 7,000,000 Pepsi Points on the Fourth of July would receive a Harrier Jet.
Instead, the commercial urged consumers to accumulate Pepsi Points and to refer to the Catalog to determine how
they could redeem their Pepsi Points.” Id. at 126. But why would consumers expend resources on an otherwise
worthless currency (Pepsi Points) unless they had been induced to do so with the promise of a “reward” in the form of
specific Pepsi products, including the advertised jet? Under less fanciful circumstances, the company may have
found itself on much shakier ground, and it is difficult to reconcile the court’s rationale with the statement (perhaps
dicta) in the Illinois Supreme Court’s 1993 decision in the American Airlines frequent flyer case. See Wolens, 626
N.E.2d at 208 (the customer’s earning or accumulating points created a contractual right to obtain benefits from the
airline in exchange for those points).
authority to impose the program on its franchisees.\textsuperscript{101} That case involved a loyalty program—and its successor program—offered to Super 8 Motels customers. The named plaintiff franchisee in the class action lawsuit entered the Super 8 system in 1986 under a 20-year franchise agreement. The agreement obligated the franchisee to participate in Super 8’s “V.I.P. Club” loyalty program. In 1993, Super 8 was acquired by Cendant Corporation, which owned a variety of other lodging brands, eventually including Wyndham, Ramada, Days Inn, Howard Johnson, and Travelodge. In 2003, Cendant consolidated its brand-specific loyalty programs into the “TripRewards Program,” which applied to all of its lodging brands.\textsuperscript{102} Cendant sought to impose the TripRewards Program on the named plaintiff as a mandatory marketing program, but the franchise agreement did not specifically grant the franchisor the right to impose unilateral changes in loyalty programs.\textsuperscript{103} The franchisee objected to the franchisor’s effort to impose a new five percent fee on gross revenue to fund the program’s rewards.

In its lawsuit, the franchisee conceded that the franchisor had the right to modify its rewards program, but argued that the franchisor could not unilaterally impose a new fee that would take an additional five percent of the franchisee’s gross revenues. On cross-motions for summary judgment, the court held that that franchisor had the right to change its system and standards of operation, but that extending that discretion to allow the franchisor to impose new fees would grant the franchisor a unilateral right to revise the contract, which explicitly designated the mandatory fees payable by the franchisee.\textsuperscript{104} The plaintiff sought damages for the class of the sum of all the five percent fees collected by the franchisor for the new loyalty program, which totaled $3.4 million. The court found material questions of fact on whether awarding that gross amount would provide the class members with a windfall, because they had not deducted any amount for the benefits the franchisees may have received (in additional customer transactions) under the new program or the value of any superseded benefits that had existed under the old


\textsuperscript{102}This type of consolidation is now the standard in the lodging industry for franchisors who own multiple brands. The primary benefit is logistical, allowing a unified loyalty program across an entire franchise network. A secondary benefit is the increased attractiveness of rewards programs, especially for business travelers who can convert rewards from lower-cost brands used for company travel into higher-end rewards when traveling on destination vacations.

\textsuperscript{103}At the time, the franchisor justified the new program under three different elements of the franchise agreement: the requirement that the franchisee comply with all rules of operation, the grant of discretion to the franchisor to establish advertising, marketing, and promotional programs, and the requirement that franchisees participate in the old V.I.P. Club program. \textit{Id.} at *5.

\textsuperscript{104}\textit{Id.} at *8. The court also noted in dicta that the Super 8 UFOC did not disclose either the additional 5% fee or any franchisor right to revise the stated fees. It is unclear from the court’s opinion whether it was citing the UFOC actually disclosed to the plaintiff or the UFOC in effect at the time the TripRewards Program went into effect.
program, such as a mandatory ten percent room rate deduction that was funded by individual franchisees.\textsuperscript{105}

3. **Privacy Issues**

Privacy issues are a growing concern for loyalty programs, because program sponsors are collecting, storing, and using potentially sensitive personal information.

One example of legal regulation imposed on loyalty programs is California’s Supermarket Club Card Disclosure Act.\textsuperscript{106} That law generally prohibits any sale or disclosure of its club members’ names, addresses, telephone numbers, or other personal identification. It also prohibits any collection of social security numbers or drivers license numbers from club members.\textsuperscript{107}

Retailers and other commercial ventures who broadly collect customer data also expose themselves to potential liability for inadvertent disclosure, inadequate protections, or negligent disclosure to third parties.\textsuperscript{108} Franchisors should be mindful of their obligation to secure any data they collect, especially if includes credit card numbers, social security numbers, or other information routinely used for identify theft.

B. **Implementation and Operations Issues**

1. **Franchise Agreements**

Franchise agreements should include provisions requiring franchisees to participate in loyalty programs, and should anticipate how those programs will be funded. That would include, for instance, specifying any fee or charge that will be imposed for loyalty programs, or employing another mechanism to fund the benefits provided to customers. If no separate fee is imposed, and funding liability is not explicitly allocated to the franchisee making the transaction, then the franchisor runs the risk that its loyalty program will need to be bankrolled from the franchisor’s royalty or, if appropriate, advertising fund fees. The FDD should disclose any fees

\textsuperscript{105} According to the case file (available on PACER), the parties later settled, with the franchisor paying the plaintiff class $2.7 million. June 29, 2010 Stipulation and Agreement of Settlement.


\textsuperscript{107} Unless the club card is also a debit or credit card or can be used as identification to cash checks; however, the supermarket cannot circumvent the intent of this restriction by making all club cards valid identification for check cashing. Cal. Civ. Code. § 1749.64 (West 2009).

\textsuperscript{108} In 2009 and 2010, Wyndham Hotels was the target of a hacking campaign that potentially exposed thousands of guest records. See, Wyndham Hotels and Resorts, Open Letter to Our Customers (June 2010), http://www.wyndhamworldwide.com/customer_care/data-claim.cfm. The FTC regularly investigates companies that fail to secure their large amounts of sensitive consumer data (usually credit card companies and banks). In 2006, the FTC secured a $10 million civil penalty from ChoicePoint for disclosing consumer credit data to subscribers using it for fraudulent purposes. The related consent order is available at http://www.ftc.gov/os/caselist/choicepoint/0523069stip.pdf.
under Item 6, and may help clarify confusion through discussion of the loyalty program in conjunction with the general advertising program under Item 11.\textsuperscript{109}

From a franchisor’s perspective, the loyalty program provision of the franchise agreement should be specific enough to require franchisees’ participation, but general enough to allow the franchisor to evolve the program over time in response to new media, new costs, and new forms of rewards. The one limit franchisors likely will face is the ability to impose new or higher fees, especially absent an explicit right to that effect.\textsuperscript{110} In at least one case, a court has rejected a franchisor’s effort to impose a loyalty program fee not specified in the franchise agreement.\textsuperscript{111}

The franchisor may also want to consider building in the flexibility to combine loyalty programs across multiple brands, even if the franchisor currently operates only a single brand. Even when multiple brands fall within a unified industry, integration can be a mechanically complex process, because the different brands may be situated very differently within that industry, may cater to different types of customers (who seek different types of rewards), and may not lend themselves to easy translation from one brand to another. As a drafting matter, the simplest approach is a general reservation of the right to combine with other loyalty programs and a commitment from the franchisee to adhere to those new program requirements.

In many instances, franchisors will not have the luxury of crafting a loyalty program from scratch, because they have dozens or hundreds of franchise agreements in effect that do not account for a loyalty program. If the franchisor can fund the loyalty program without imposing non-trivial fees on its franchisees, then the franchisor likely can successfully implement the program without amending franchise agreements. In particular, most franchise agreements will grant the franchisor broad discretion to revise its operations manual, and in the absence of substantial additional cost, franchisees will be obligated to adhere to a loyalty program implemented through revisions to the operations manual.\textsuperscript{112}

If a loyalty program will require new, unscheduled fees for existing franchisees, then the franchisor’s options will be limited. The franchisor first will

\textsuperscript{109}There currently is no explicit requirement to disclose loyalty programs. They would arguably fall under the Item 11 requirement to disclose the “media” the franchisor may use in its advertising program, though that seems an awkward fit for a use that is clearly outside the traditional advertising model.

\textsuperscript{110}Which right should be troubling to any franchisee of even modest sophistication. It is unlikely that any franchisee counsel would recommend executing an agreement that granted the franchisor an open-ended right to impose new fees, at least absent a cap on the upper end of those fees. That kind of open-ended fee also complicates the fee disclosure under Item 6 of the franchise disclosure document, which requires detailed information on the variability of fees imposed.

\textsuperscript{111}See Bird Hotel, supra note 97.

\textsuperscript{112}However, if that requires diversion of funds that otherwise would be used for general advertising purposes, then franchisees may object if their franchise agreements narrowly define the franchisor’s permitted use of advertising funds.
need to demonstrate that the new loyalty program is worth the additional investment, and obtain franchisees’ consent to impose the new fees. Franchisees also may expect the franchisor to absorb a portion (or even all) of the new cost until the benefits of the new program can be validated. Alternatively, or in conjunction with a cost sharing approach, the franchisor may be limited to a loyalty program that is phased in over time, as new franchisees join and existing franchise agreements are renewed with updated terms. The downside of a gradually-introduced loyalty program is that it is likely to result in patchwork coverage and limited availability of customer benefits, and that lack of uniformity may defeat the underlying purpose; in fact, the inconsistency could actually have the reverse effect and alienate customers more than it generates loyalty. For that reason, franchisors should expect to participate financially in any loyalty program that is not cost-neutral and cannot be widely instituted under the system’s existing franchise agreements.

2. **Program Materials and Disclosures**

Franchisors should presume that their loyalty programs are contractual commitments to the brand’s customers. As such, loyalty programs should be crafted to include the following elements, terms, and conditions, which should be clearly disclosed to customers (and franchisees):

- **Program sponsor.** Identifying the program sponsor is particularly applicable in the franchise setting, where the program sponsor likely is not the merchant making any individual sale, and may be a parent or affiliate of the franchisor. If the franchisor were to outsource its loyalty program to a third-party operator that was intended to be directly in privity with customers, that fact should be clearly disclosed to help defeat any breach of contract claim against the franchisor or a franchisee.

- **Eligibility requirements, expiration, and lapse triggers.** Most franchise systems will open their eligibility to all customers, but if that eligibility is limited (for example, to those who meet certain purchase thresholds or who live only in certain states), that fact should be built into the loyalty program’s membership restrictions, and should also be clearly communicated to franchisees, who will be on the front lines discussing the program with customers. Also, if there are any triggers that would close a customer’s loyalty membership (such as an extended period of non-use), or reduce member benefits (such as expiration dates on accrued points), those should be clearly disclosed.

- **Fees.** Any fees imposed for joining a loyalty program or exercising benefits should be established at the outset.
• Points. Subject to the franchisor’s right to modify the program, the then-current system for obtaining and accruing points (or the program’s equivalent) should be defined and disclosed.

• Use of points. The franchisor should disclose, again subject to its right to modify, how customers may translate their points into specific benefits. The franchisor also should consider how points may be adjusted or revised (for example, upon return of a purchase that generated the points), whether points may be transferred to another program member or consolidated across a member’s multiple accounts, any minimum and maximum point levels accruable before the entitlement to benefits may or must be exercised, whether points are redeemable for cash, and whether points may be purchased directly.113

• Program coverage or availability. In the franchise setting, where it can be challenging to secure full participation by all franchisees (which could be the result of older contracts that do not mandate participation, obstinate franchisees who balk despite requirements, or other factors outside the control of the franchisor), the availability of the program should be clearly defined. At the least, customers should be forewarned that loyalty points and benefits may only be available “at participating locations” or as otherwise limited.

• Franchisor’s right to change program or benefits. The franchisor must reserve the right to change the program, including the manner in which points accrue (or the value of points per transaction or amount spent), the duration or expiration of points, the value of points (including both future and accrued points), and the availability of benefits. If feasible, franchisors also should include the right to terminate the program altogether, which has been found to justify any other changes made.114

Franchisors also should consider whether and how their loyalty program would integrate with a gift card program, or would piggyback on gift cards as the

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113But see Leonard v. Pepsico, 210 F.3d 88 (2d Cir. 2000), for the hazards of allowing points to be purchased, especially if the marketing department gets too creative in its promotion of the program. When the customer in the Harrier jet case sought to redeem the fictional prize, the company responded: “The Harrier jet in the Pepsi commercial is fanciful and is simply included to create a humorous and entertaining ad. We apologize for any misunderstanding or confusion that you may have experienced and are enclosing some free product coupons for your use.” Id. at 120. They also returned his check.

114Grossman v. USAir, Inc., No. 0109, 1997 WL 1433744 33 Phil. Co. Rptr. 427, 433 (Pa. Com. Pl. Apr. 16, 1997) (“If USAir can terminate the [frequent flyer program], essentially wiping out miles that members spent significant money with USAir to accrue, why can it not take the lesser step of increasing the mileage levels needed to obtain free travel? This court believes the only reasonable interpretation of the provisions quoted above [allowing the airline to terminate the program altogether] is that USAir can.”). Of course, a terminable-at-will loyalty program may not generate much loyalty from customers.
means of tracking loyalty accounts.\textsuperscript{115} The advantage of a combined program is that the franchisor can track data from a repeat customer through a unified system, including sales, product preferences, days and hours of visits, and frequency and amounts of gift card reloads, and can integrate that data with other information known about the customer through the loyalty program, which could include rich information on the customer’s demographic profile. By the same token, a unified system is more complex logistically, especially when a franchisor is reliant on franchisees to collect and report information.

3. **Compensation for Customers’ Exercise of Rewards**

In a franchise system, there are a variety of ways to compensate or account for the exercise of rewards by customers. As with gift card redemptions, this becomes an issue because the customer may redeem points “earned” at one location for rewards given at another location, and saddling the redeeming franchisee with the full cost of providing those rewards likely would cause inequities among franchisees. For example, in the hotel industry, certain properties are heavily trafficked by vacationers redeeming points earned elsewhere, and those vacation destination hotels would be unreasonably burdened by a system that required them to absorb the full cost of providing those redemptions.

There are at least four basic mechanisms for awarding and redeeming points in a franchise system loyalty program: (1) a general fee (usually a percentage of the revenue generated) on all transactions to fund a pool used to pay for redemptions; (2) a fee, based on the number of points awarded, charged to the franchisee who awards points when that original sale is made; (3) a fee imposed on the originating franchisee when points awarded by that franchisee are redeemed; and (4) requiring each franchisee to redeem points for no additional compensation. The pros and cons of each approach are summarized here:

\textsuperscript{115}This is probably most relevant in the restaurant industry, where frequent customers have the overlapping interests of stored-value cards and loyalty program benefits.
<table>
<thead>
<tr>
<th>System</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redemption pool funded through gross revenue percentage fee</td>
<td>Simple; agnostic approach to origin of revenue</td>
<td>Reduces flexibility to award points on basis other than underlying purchase price; may be viewed by franchisees as a hidden mechanism to increase overall cost of system¹¹⁶</td>
</tr>
<tr>
<td>Fee charged to awarding franchisee based on the number of points awarded</td>
<td>Allows additional flexibility to tie cost of rewards to value of points given (e.g., if points are increased to drive desired marginal transactions such as weekend stays at business travel-oriented hotel); may be viewed as more equitable by franchisees</td>
<td>More complex to administer; certain franchisees will inevitably pay more if points are weighted for certain transactions and may consider that unreasonable</td>
</tr>
<tr>
<td>Fee imposed on awarding franchisee when points are redeemed</td>
<td>Imposes cost on franchisees only where awards actually generate future economic event; draws clear connection between costs and benefits of loyalty program</td>
<td>Very difficult to administer, because each point must be tracked from origin to redemption; may generate unpredictable swings in charges and a long tail on when and whether awarded points will be redeemed</td>
</tr>
<tr>
<td>No charge for awarding points and no compensation for redeeming points</td>
<td>Simple; franchisor need only track a member’s total points and deduct when redeemed</td>
<td>Likely seen as unreasonable burden on franchisees who disproportionately redeem points; may encourage excessive point awards because system imposes no cost on awarding points</td>
</tr>
</tbody>
</table>

¹¹⁶In comparing franchise systems, it is common for franchisees or industry commentators to add up all fees imposed as a percentage of gross revenue, even where a fee—such as this one—is ultimately a mechanism to redistribute funds fairly across a network of franchisees.
Franchisors may also use a mix of these different systems, or at least combine the last (no charge or compensation) with one of the first three. Whether to use a mixed system may depend on the types of rewards offered to program members. For example, a franchisor may want to compensate franchisees for rewards of free products (food, beverages, hotel nights, etc.), but require all franchisees (without compensation) to provide loyalty program members with benefits such as free wi-fi and internet access, moderate price discounts, or upgrades to product sizes, room class, or the like.

4. **Advertising Fund Use**

In many instances, franchisors have sought to use their system’s designated advertising fund to support a loyalty program. This is particularly the case where the system carries a significant number of older franchise agreements that do not explicitly address or separately collect fees associated with loyalty programs.

Most franchise agreements will address their advertising program broadly enough to allow those designated funds to be used to support a loyalty program, because franchisors generally reserve very broad rights to use those funds for any purpose that supports, promotes, and markets the brand. The evolution of marketing, and the greater emphasis on social media that connects directly with individual customers, makes it even easier to justify loyalty programs as part of a broader advertising program.

Any fees imposed for loyalty programs should be provided for in the franchise agreement itself. Absent an explicit right to charge franchisees for the loyalty program, a franchisor faces serious risk if it later seeks to impose those fees.

5. **Record-Keeping**

Loyalty programs require ongoing tracking of and access to a database of points, transactions, visits, or other metrics used to reward frequency. In a franchise system, loyalty programs usually also include a financial mechanism to accept revenue and allocate it to the franchisees redeeming those rewards. For these reasons, a franchisor’s record-keeping system for its loyalty program must be robust.

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117For example, in the *Bird Hotel* action, the franchisee did not challenge the franchisor’s right to use the existing advertising fund payments for the new loyalty program. *Bird Hotel*, 2010 WL 572741.

118That said, a franchisor may find it hard to justify committing all advertising funds to its loyalty program (which seems an unlikely business decision in any event). As a component of a program that incorporated traditional media and promotions, a loyalty program is much easier to rationalize.

119See *Bird Hotel*, 2010 WL 572741.
and flexible. At their most successful, loyalty programs will include millions of members and annual transactions; hundreds of millions of points awarded, banked, and redeemed; multiple brands with varying award categories and redemption levels; thousands or tens of thousands of terminals or point-of-sale devices adding and redeeming points; and national or international scale. Any franchise system installing a new loyalty program should scale its record-keeping mechanisms to its projected size, and then add the flexibility to grow and expand.

Loyalty programs systems should include strong security controls to protect member information, particularly if that system is integrated with gift card systems that include credit card or social security numbers. If the loyalty program will be administered by a third-party service, then that service should be vetted carefully to confirm both its capacity to handle the transactions involved and the security measures it takes to protect member data. Any agreement with a third-party vendor should include strong indemnification provisions in the event there is a breach or inadvertent disclosure, and that indemnity should extend to any actions brought by regulators and the resulting fines or penalties. Franchisors also should review their insurance coverage and, if not already included, consider obtaining liability insurance that would cover claims arising out of data disclosure.

Loyalty programs may also have tax and accounting implications, which should be discussed with the corresponding experts. Those implications may include requirements about how and when revenue generated for awards pools is booked, how and when payments made from that pool to compensate redeeming franchisees are expensed, and the contingent liability carrying requirements for loyalty program funds and for accrued but unredeemed points. These issues can be particularly complex in the franchise setting, where there are economic implications for both the franchisee and franchisor in processing loyalty program transactions.120

6. Overall Effectiveness

Loyalty programs, like all advertising and promotional activities, are a means to an end. If used well, communicated effectively to customers, administered efficiently, and coordinated with other efforts, they can play a valuable role in the relationship among a franchisor, its franchisees, and their ultimate customers. If used poorly, administered haphazardly, and unsupported by other marketing components, they are at best a distraction and at worst an active antagonistic element for the customer and for the franchisor/franchisee relationships.

In evaluating an existing or proposed loyalty program, a franchise system should consider the following:

120These issues are beyond the scope of this paper and are likely substantial enough to fill an entire paper of their own. But they certainly should be addressed by franchisors with their accounting professionals, because of the requirement that most franchise systems prepare and disclose audited financial statements.
• Is a loyalty program necessary in this industry to meet consumer expectations and maintain a competitive stance against other industry players?

• Can the franchise system effectively install and administer the program at reasonable cost and without undue devotion of resources?

• Will rewards drive valuable marginal transactions and revenue, or will they simply provide an additional benefit for customers making purchases they would have made anyway?

• Does the franchisor have the contractual rights and relationship equity to impose a loyalty program on its franchisees, and will franchisees be able and motivated to employ that program effectively?

• Does the franchise system inherently provide an equitable and reasonable opportunity to issue points and redeem awards?

• Can the awards system be explained clearly and succinctly to customers?

• Does a loyalty program tie coherently into the overall brand identity, brand strategy, marketing programs, alternative media, and customer relationships of the franchise system?

Loyalty programs can be administratively complex, difficult to articulate to customers, and expensive, and it is difficult to determine exactly what kind of customer behaviors they reinforce. In the airline and hotel industry, their ability to inspire customer loyalty and repeat transactions appears unassailable.\textsuperscript{121} In the restaurant and other franchise-heavy industries, where loyalty programs are a newer phenomenon, their success rates are still untested.

\textbf{IV. Conclusion}

Gift card and loyalty reward programs can offer many benefits to franchisors, franchisees and their consumers. Neither type of program, however, should be implemented without a full understanding of both the legal and practical issues that can accompany them. Gift cards are heavily regulated and identifying and complying with the applicable rules can be burdensome, expensive and confusing. In contrast, there are few laws directed specifically to loyalty programs, requiring franchisors, in some instances, to test uncharted waters. Nevertheless many businesses, including franchisors, have concluded that the profits, brand awareness

\textsuperscript{121}In fact, those very sponsors are now victims of the success of those programs, which are now nearly ubiquitous in the airline and hotel industries, and therefore offer limited competitive advantage. Having a loyalty program is now part of the price of admission to be a major player in those arenas, and in both industries, they represent significant expenses to the program sponsors.
and loyalty that can stem from these programs are worth the risk of implementing them.
DAVID M. BYERS

David Byers is director, corporate counsel, licensing and franchising, for Starbucks Corporation. David serves as the primary legal counsel for the Starbucks licensed store system, and also provides support for the Seattle’s Best Coffee franchise system. David’s practice includes negotiating and drafting development and license agreements, managing regulatory exemptions, advising on dispute resolution with store licensees, and counseling the licensed store client group on strategic implementation, systems issues, marketing and advertising, and other legal matters.

David is an Associate Editor of the Franchise Law Journal, and has co-authored articles in the Franchise Law Journal and other legal publications on Washington franchise law, litigating disclosure claims, open price terms in franchise and distribution contracts, and franchisors’ common law duties to franchisees. David has presented on franchise law and other business law topics on a variety of panels. He also serves as a member of the Washington State Bar Association Rules of Professional Conduct Committee, and is a volunteer lawyer for the Washington Lawyers for the Arts legal clinic.

David was previously a shareholder and co-chair of the Franchising & Distribution practice group at Graham & Dunn PC in Seattle, where he worked with clients in a variety of franchise and distribution industries, providing counseling and support in building franchise systems, drafting franchise and development agreements and franchise disclosure documents, managing regulatory filings and exemptions, drafting distribution and agency agreements, and advising clients on dispute resolution and other related matters. David was co-host and moderator of the International Franchise Association’s Franchise Business Network, Pacific Northwest chapter. David also served as the firm's General Counsel, chair of the Loss Prevention Committee, and chair of the Attorney Hiring Committee.
TYWANDA H. LORD

Tywanda H. Lord is a partner in the law firm of Kilpatrick Stockton LLP and is resident in its Atlanta office. Tywanda focuses her practice in the areas of trademark and advertising law. She serves as principal trademark counsel for a number of companies with well-known brands and large brand portfolios and manages their trademark portfolios and disputes throughout the world. Tywanda has significant experience representing clients in disputes in federal court and before the Trademark Trial and Appeal Board. She routinely advises clients on national advertising and marketing campaigns, including evaluating advertising claims, drafting sweepstakes rules and drafting and negotiating sponsorship and celebrity endorsement agreements.

She is a frequent speaker on intellectual property and advertising topics for numerous organizations, including the American Bar Association, Promotion Marketing Association, and the National Bar Association. Her articles on intellectual property issues have been featured in The World Trademark Reporter, The Franchise Law Journal, and Managing Intellectual Property. She is a member of the Editorial Board and the Production Committee chair for the ABA Section of Intellectual Property Law’s Annual Review of Intellectual Property Law Developments. Tywanda serves as the co-chair of her firm’s Diversity Council and is a member of the Investigative Panel for the State Bar of Georgia.
Mr. Lowell is an internationally recognized leader in franchise and distribution law, and has counseled and represented clients across a broad spectrum of industries (including restaurants and food service, car rental, hotel/motel, health care, financial services, high tech, real estate, and retail).

His experience includes extensive analysis as to whether arrangements constitute “franchises”; drafting and negotiating domestic and international franchise, distribution and license agreements; preparation and filing of disclosure documents; counsel and advice regarding the establishment and operation of franchise and distribution systems; regarding the implementation of system changes; counsel and advice regarding termination, transfer and renewal obligations; dispute resolution including representation before federal and state government agencies; mediation; due diligence reviews and document preparation in connection with public offerings, mergers, and acquisitions; and trademark and other intellectual property matters.

Mr. Lowell is also the author of numerous articles and books on trade regulation and franchise law, and is a frequent lecturer on those subjects. He is a member of the American Bar Association’s (“ABA”) Forum on Franchising; Franchise Law Committee of the ABA's Section of General Practice (Former Co-Chair); ABA’s Business Law, Intellectual Property Law, and International Law Sections; International Franchise Association's Legal/Legislative Committee; Licensing and Franchising Law Committees of the American Intellectual Property Law Association; Licensing Executives Society, and Franchising Committee of the International Bar Association. He is the Former Editor of the Franchise Law Journal, author of Multiple-Unit Franchising: The Key to Rapid System Growth, and co-author of Franchising: Regulation of Buying And Selling A Franchise, How to Avoid Disputes With Franchisees, Franchise Sales and Full Agreement Compliance, Managing the Franchisor's Legal Concerns, and Investigate Before Investing. He has been appointed to numerous leadership positions in the franchise community, including: Chair (1992-1995), Governing Committee, ABA Forum on Franchising; Program Chair, 1990 Annual Forum on Franchising; Franchise Advisor, Franchise and Business Opportunities Committee; Arbitrator, Franchise Arbitration and Mediation, Inc., and Delegation Leader, Citizen Ambassador Program, International Franchise Delegation to the Far East.

Mr. Lowell writes and speaks extensively on franchise-related topics in a variety of forums. He has been listed in The International Who's Who of Franchise Lawyers, in The Best Lawyers in America; and in Who's Who in America. Washingtonian magazine has named him one of the Best Lawyers in Washington. Mr. Lowell was also listed in the 2005-2010 Who's Who Legal: The International Who's Who of Business Lawyers and named both a Virginia Super Lawyer and a Washington, DC Super Lawyer. Franchise Times has named him to its list of “Legal Eagles,” the top 101 franchise lawyers in the US and Canada. The respected English research firm Chambers and Partners recognizes him in Chambers USA: America's Leading Lawyers for Business, calling him "a technically superb transactional lawyer” and “an expert counselor.”

Bret Lowell received his law degree from Georgetown University Law Center in 1978.