

A Warning From Delaware For Gift Card Programs



Law360, New York (May 02, 2014, 12:59 PM ET) -- Delaware has gained national recognition for its efforts to step up collection of unclaimed property. Despite being among the smallest states in the country, Delaware's unclaimed property collections have ballooned over the past decade to where only California and New York collect more per year, and also make up the state's third largest source of revenue behind only personal income and corporate franchise taxes.

Delaware is not alone: Today, all 50 states and U.S. territories have provisions on their books requiring certain unclaimed property be remitted to the states after the expiration of an inactivity period. To balance outcry over aggressive auditing tactics, Delaware enacted an unclaimed property disclosure program in 2012, intended in part to curb fears of large corporations considering reincorporating elsewhere, and in part to preserve a reputation of being business friendly. The deadline to join the voluntary disclosure agreement program is fast approaching on June 30.

In a most bizarre turn of events, an ex-senior officer of Card Compliant (a company formed to help affected companies avert having to report unredeemed gift cards to the states, including the state of Delaware) has initiated a whistleblower lawsuit with the state of Delaware against 33 major retailers, the National Restaurant Association and the whistleblower's ("relator's") predecessor employer.

The complaint alleges that these companies, including the relator's employer, Card Compliant, and its predecessor, CardFact LLC, violated the Delaware False Claims and Reporting Act by knowingly failing to report and remit the value of unredeemed gift card balances in a scheme to deprive the state of hundreds of millions of dollars due to the state under its unclaimed and abandoned property laws.

The qui tam case was brought by the relator, who is an ex-officer of CardFact and Card Compliant (the primary named defendants). Interestingly enough, after leaving the company, the relator subsequently held positions at Kelmar Associates, the largest third-party contingent fee audit firm hired by Delaware and approximately 20 other jurisdictions to conduct unclaimed property audits.[1]

In the complaint, the relator alleges that the defendants, in establishing the gift card avoidance scheme,

created “sham” contracts identifying Card Compliant as the holder of the gift cards in exchange for an annual fee, when in fact the gift cards were always within the possession, custody and control of the companies that issued the gift cards.

The complaint also alleges that Card Compliant and the shell corporations it allegedly created in Ohio and Florida, were never the holders or the issuers of the gift cards, and if unredeemed gift certificates were never issued or held in an exempt state such as Florida, Ohio or Virginia, and did not contain names and addresses, the unredeemed balances were reportable to each company’s state of incorporation or formation.

The case, which was initially filed under seal in June 2013, was just unsealed and released to the public. Delaware’s general counsel has indicated his intent to pursue the case against the named defendants.

Potential Consequences

The potential consequences to the named defendants are significant. Under the provisions of Delaware’s False Claims and Reporting Act, if the relator’s claims are upheld by the court then the named defendants could be required to report and remit, as unclaimed property, all of the previously unremitted gift card balances to Delaware together with interest and penalties, which amounts up to 125 percent of the unredeemed balance plus three times the amount otherwise due (arguably excluding interest and taxes). This could amount to hundreds of millions of dollars.

Complaint Implications

This action brought on by the whistleblower has implications that extend well beyond the 33 named defendants. Companies named in the suit will have ample opportunity to present their position regarding the contractual agreements entered into with CardFact and whether they were valid and enforceable.

As this case makes its way through the judicial process in contemplation of a jury trial in the state of Delaware, the questions to be answered for corporate companies that have established gift card companies include:

Does the gift card company, whether established through Card Compliant or independently established in a state that exempts or excludes gift certificates from the definition of unclaimed property, have economic substance sufficient to withstand judicial scrutiny and the avoidance of the unclaimed property laws?

Whether or not the whistleblower claimants prevail in making their case against the named defendants, Delaware and other states that treat unredeemed gift cards as abandoned property are likely to increase their scrutiny of all entities that issue gift cards to their customers. The proliferation of new and inventive stored value, gift cards/gift certificates, merchandise credit and reward loyalty programs does provide ample incentive for the states to enhance their enforcement actions.

Even before this complaint, we have seen multiple states and their third-party contingent fee auditors initiate a coordinated audit program of major retailers. This recent qui tam case will likely fuel additional audits of retailers and service providers of all size and scale for compliance with the unclaimed property rules.

What Can a Company That Issues Gift Cards or Gift Certificates Do to Mitigate Risk Should Their Gift Card/Certificate Programs Come Under Review by the State's or Their Third-Party Contingent Fee Auditors?

There are some rather straightforward steps companies and counsel can take to mitigate exposure relating to any unreported gift card/certificate programs including:

1. Review your existing gift card/certificate offering programs, including merchandise credit return policies and practices to determine whether or not the programs meet the existing guidelines issued by the states. This may not be an easy task given that each state has different rules, definitions of reportable property and more than 25 states provide some form of limited or total exemption of gift card/certificates.
2. For those organizations that have formed captive gift card/certificate management companies with the intent of averting the reporting of unclaimed property, it's time to examine both the form and substance of those entities. The qui tam complaint provides some very helpful insights into what are the "trigger points" increasing the likelihood of a challenge.

Despite their best intentions, many organizations that have formed captive companies have failed to execute on the substantive activities required to support the true arms-length relationship required for the gift card/certificate management company to be recognized as the true owner of the gift cards/certificates. Short-cutting these requirements may expose both past and ongoing unredeemed balances to the various state unclaimed property reporting/remittance requirements.

3. If not already under audit, most states including Delaware have voluntary disclosure programs that offer significant opportunities for companies that issue gift cards/certificates to voluntarily come forward and report/remit amounts that are subject to the state's unclaimed property guidelines without the imposition of interest/penalties. Other benefits include a reduced look-back period and opportunity to avert audit by one or more third party contingent fee audit firms.

Further, these programs also provide companies that believe they already are in compliance with the states' rules to secure agreement from the states rather than risk scrutiny at a later date either through a similar qui tam action or via audit. Organizations formed in Delaware currently have until June 30, 2014, to enter into the state's relatively new and enhanced voluntary disclosure program. More information on Delaware's VDA program is available at www.DelawareVDA.com.

4. Any organization that has contractually entered into an arrangement with any of the named

defendants in the qui tam case (CardFact, Card Compliant, or similar entities), should be advised to revisit those arrangements and give consideration to possible alternative structures, or at a minimum renegotiate the existing terms and conditions with those named providers.

5. Seek outside assistance. This qui tam suit serves as notice that the rules surrounding the various gift card/certificate offerings have broad and often unintended consequences. Any organization that entered into transactions with the named defendants CardFact, or its successor Card Compliant could fall subject to a qui tam action initiated in another jurisdiction that has similar whistleblower statutes.

Additionally, expect increased audit activity by the states and their third-party contingent fee auditors as they may begin to closely scrutinize companies that entered into arrangements with CardFact or Card Compliant along with those companies that have formed captive gift card management companies organized in favorable jurisdictions. Now would be the opportune time to solidify or modify existing arrangements that are prone to scrutiny.

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[1] “Whistleblower” actions in Delaware and other states include substantial rewards to those who come forward, if the action is successful because their information and testimony. In Delaware, the rewards range between 15-30% of the money or funds recovered by the state.