

Is Your Franchise Still Breaking the Gift Card Laws?

By Daniel R. Garner

One of my law school buddies is a class action plaintiffs' lawyer. During law school, when the rest of us were out searching for jobs, he was searching for products that did not work. He loved spending time in the law library, finding arcane regulatory schemes that no one else could stay awake long enough to read, and dreaming of ways to make companies pay for not complying.

Whenever we go out, conversation inevitably turns to his latest idea for a class action, and he usually does most of the talking. But in early 2010, he let me lead the conversation. Congress had passed the Credit Card Responsibility Act in February 2010, and the Treasury's rules enforcing the law, called Regulation E, were to go live on Aug. 22, 2010. One of my firm's biggest clients asked

us to figure out the rules and tell them what they needed to do to comply.

I was startled by what I discovered, and I shared it with my buddy. "Did you know gift cards can't expire for five years now?" I asked my friend incredulously. "And there are all sorts of bizarre rules about when you can charge fees and what disclosures have to be on the card. They apply to nearly every business in the country, and most of them don't even know it. It's a nightmare!" He began rubbing his hands together, and after a few minutes, without even finishing his drink (or more importantly from my perspective, paying his tab), ran out of the bar to the local Walmart to rifle through the gift cards and find somebody to sue.

It has been two years since Regulation E went into effect, but not a month goes by without my friend texting me a picture of a gift card containing an illegal expiration date or fees. Sometimes the card is from a small local company, and sometimes it's from a multinational corporation. But every time, the

card represents easy money for him. And every time, it is a problem the company could have easily avoided.

Regulation E and Its Application to Franchising

Regulation E does two primary things. First, it forms a baseline set of rules for issuing and selling gift cards or running sales promotions that incorporate gift cards (for example, daily deal promotions like Groupon or Living Social). Second, Regulation E provides a framework for running customer loyalty programs that incorporate gift cards.

Regulation E matters to franchisees for many reasons. First, it matters because it applies to the sale of any types of products or services. In fact, when a client asks me if gift card rules apply to their company, I always say "Yes!" even if I don't yet know what the company does. Put simply, Regulation E applies to every single company that issues or sells gift cards within the United States, from the initial issuer to the retail seller. (The only major exception is that it does not apply to gift cards issued

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solely in paper form. *See* 12 C.F.R. § 205.20(b)(5).)

Second, Regulation E matters because the failure to comply can cause serious legal consequences. A violation of Regulation E carries potential for both civil and criminal penalties, including the possibility of fines of up to \$5,000 per violation and/or imprisonment up to a year. And perhaps most importantly for the bottom line, Regulation E poses a serious risk of costly civil litigation, including class actions. *See* 15 U.S.C. § 1693m(a)(2)(B) and 15 U.S.C. § 1693m(a)(3). Both Groupon and Living Social have faced class action lawsuits alleging Regulation E violations in the last two years.

Third, Regulation E matters because it is one of the only laws that specifically targets customer loyalty programs. Unsurprisingly, as the economy struggles, franchises are struggling to maintain their core customer base. Consequently, customer loyalty programs making use of gift cards are rising in popularity as a way to reward loyal customers and generate repeat business.

Fourth, Regulation E matters because of two things it does not do: 1) It does not pre-empt state laws that are more protective of consumers; and 2) It does not regulate the escheat of gift cards. This means that not only do franchisors need to comply with the federal regulations, but they also need to know the law in every state where they issue or sell gift cards.

Finally, Regulation E matters for a franchise's bottom line in terms of both consumer demand and public relations. Gift cards are a

huge source of consumer interest. In fact, according to the National Retail Federation, gift cards have been the most requested item on holiday wish lists in the United States every year since 2007. If a franchise's gift card practices are not up to snuff, consumers (and the media) will probably talk about it, and contrary to the old adage, that's the kind of press that no company wants.

Gift Card Rules

Understanding gift card rules begins with the question, "What is a gift card?" This is a vital question, because if something does not count as a gift card, then Regulation E will not apply. Regulation E essentially breaks "gift cards" down into three categories: 1) gift certificates, 2) store gift cards, and 3) general use prepaid cards. Determining exactly which category a card falls into can be complicated, but think about it this way: If a franchise (a) issues or sells a (b) card, code, or other device (c) on a prepaid basis in a specified amount that (d) is redeemable upon presentation at any one or more of its franchise locations, then the company is selling a gift card and must comply with Regulation E. A "loyalty card," discussed below, is simply a gift card that is exempted from Regulation E.

At its most basic level, there are three major components to Regulation E's gift card rules: 1) expiration, 2) fees, and 3) disclosure. If a franchise complies with these three components, as simplified below, it will significantly reduce the risk of legal challenge. First, no company may sell a gift card where the underlying funds ex-

pire within five years of issuance. (However, by taking certain steps, a company can expire the card itself. *See* 12 C.F.R. § 205.20(e)(3)(iii).) This is the single most important rule to follow, and the one that will likely cost a franchise the most if it is violated.

Second, a company may not charge gift card fees during the first year after a sale. After that, it may charge a fee (such as for dormancy or inactivity), but only if it meets three requirements: 1) the consumer must not have used the card for at least a 12-month period, 2) the customer cannot be charged more than one fee per month, regardless of the kind, and 3) all necessary disclosures must be made. *See* 12 C.F.R. § 205.20(d).

Third, the company must make certain disclosures on all gift cards. Disclosures can be tricky, because not only will the company have to comply with Regulation E, but it will also have to disclose any specific terms or conditions that apply to the franchise brand's gift card. At a minimum, however, Regulation E requires "clear and conspicuous disclosure" of the expiration date (if there is one) and the type, amount, and timing of any possible fees, both before the customer purchases the card and on the card itself. A disclosure is "clear and conspicuous" if it is readily understandable, and the location and size of the disclosure is readily noticeable to consumers. *See* 12 C.F.R. § 205.20(c)(1). Take note of the fact that the disclosure rules apply regardless of whether the customer purchases the gift card online, by telephone, or in person. *See* 12 C.F.R. § 205.20(d)-(f).

The customer must also be able to call a toll-free telephone number and visit a website (assuming the franchise uses a website to advertise or sell gift cards) offering free information regarding potential fees. *See* 12 C.F.R. § 205.20(f)(2).

Loyalty Card Rules

Technically, the loyalty card regulations are simply an exemption from the gift card rules. If a company meets the disclosure requirements for issuing a loyalty card, it does not have to worry about the remaining gift card rules. What this means in practice is that these types of gift cards can expire at any time, and the franchise can charge dormancy, activity or service fees, etc., at any time, if the customer received the proper disclosures about the expiration date, amount, type and timing of any fees.

Compliance with these disclosure rules requires several steps. First, the front of the card must state the expiration date for any funds on the card. *See* 12 C.F.R. § 205.20(a)(4)(iii)(B). Second, the front of the card must state that the card is issued for loyalty, award or promotional purposes. *See* 12 C.F.R. § 205.20(a)(4)(iii)(A).

Additionally, just as with a gift card, the customer must receive a clear and conspicuous disclosure of the terms and conditions associated with the card, including the amount and type of any fees and the conditions for incurring them. Unlike with a general gift card, however, these disclosures do not have to appear on the card itself and may be in a separate packet accompanying the card. *See* 12

C.F.R. § 205.20(a)(4)(iii)(C).

Finally, if the card is subject to any fees, the franchisor must maintain a toll-free telephone number, and, if one is separately maintained, a website that will allow customers to receive free information regarding the terms and conditions of fees. *See* 12 C.F.R. § 205.20(a)(4)(iii)(D). The cards must identify the telephone number and website, but may do so on the back of the card.

Potential Ramifications

The potential ramifications of gift card laws are surprisingly extensive, from both a legal and practical perspective. For example, some federal record-keeping and anti-money-laundering requirements apply to the sale of all gift cards. There are also legal and practical concerns regarding what terms and conditions a franchisor should apply to its card.

Additionally, because Regulation E does not pre-empt state laws that are more protective of consumers (12 C.F.R. § 205.12(b)(1)), the franchisor needs to ensure that its gift card program complies with the law in every jurisdiction where it does business. This is quickly escalating in importance all over the country, as more and more states are regulating gift cards through escheat statutes. If a franchisor has not analyzed the impact of escheat laws upon its breakage model, it could be in for a nasty surprise when it has to turn over funds to the state instead of applying them to its bottom line.

Finally, not only will a franchisor need to comply with such laws, but it also will need to

manage compliance costs. For example, if a franchise sells a very large number of gift cards, it might incur high fees from card services providers to keep such cards active for years into the future. It may make sense for the franchisor to explore Regulation E's somewhat convoluted options for expiring the gift card itself without expiring the underlying funds, as this could potentially save large franchisors hundreds of thousands of dollars.

Still, the first thing to do is to comply with the base requirements of Regulation E concerning expiration dates, fees, and disclosures. If a franchise stays on top of these, it will avoid the lion's share of legal liability associated with gift cards. That, in turn, will give the company more time to focus on growing the profitability of its gift card program, which, believe it or not, Regulation E can actually help franchisors achieve. And it also means my class action attorney friend won't be sending me a picture of your gift card.