

PUBLICATION

Loyalty Reward Programs Raise a Host of Questions under State Unclaimed Property Laws

July 1, 2011

Unclaimed or abandoned property is a multi-billion dollar revenue source for states. States are constantly seeking out new types of unclaimed property, especially given difficult fiscal situations. According to the National Association of Unclaimed Property Administrators (NAUPA), almost \$33 billion of unclaimed property is currently held in state treasuries. As unredeemed balances on gift cards and stored value cards (i.e., breakage) have become a common type of unclaimed property in most states, will they also turn their attention to unused loyalty reward program values? If so, how should issuers of loyalty reward cards respond?

Loyalty Reward Card Programs

Loyalty reward cards are structured marketing programs that reward and encourage loyal behavior on the part of customers. These programs are variously described as discount cards, club cards or rewards cards. The owner of the card is typically entitled to either a discount on current or future purchases or an allotment of points that can be used toward making future purchases. According to one study, \$48 billion of consumer loyalty reward points are dispensed each year, but at least \$16 billion of those points are never used by consumers.¹

The study also found that the financial services sector provides the most rewards, at \$180 billion per year, followed by the travel and hospitality sector at \$17 billion a year. Although retailers make up 40 percent of all loyalty reward program memberships, the study indicated that the retail sector issues loyalty rewards of \$12 billion a year. In 2010, loyalty reward memberships in the U.S. exceeded 2 billion, up from 1.8 billion memberships in 2009. On average, a U.S. household has 18.4 memberships.

An Unclaimed Property Primer

Property is presumed abandoned by the owner after the running of a state's dormancy period applicable to the type of property involved (typically three or five years; one year for unclaimed wages) and subject to escheat to a state.² In general, the unclaimed or abandoned property is reportable first to the state of the owner's last known address. If the holder's records do not contain the owner's name or address, or if the last known address state does not escheat the property, then the holder's state of domicile (incorporation) has the secondary right to the unclaimed property.³

Recently, some states have begun using a "deemed owner address" rule for gift and stored value cards. If the issuer of the gift card does not maintain the owner's last known address in its records, then the owner's address is presumed to be in the state where the card was sold.⁴

States have become increasingly aggressive and routinely schedule holders for unclaimed property audit examinations. Employment of third party audit firms by states, such as Kelmar Associates, LLC, ACS Unclaimed Property Clearinghouse, Revenue Discovery Systems and Verus Financial LLC, is now common. These firms typically audit holders on behalf of one or more states for a contingent fee that is measured by a percentage of unclaimed property recovered from a holder. It is common for an audit to cover a 10-year look-back period, plus the applicable dormancy period, for a 13- to 15-year audit period. Certain states, such as

Delaware, will audit as far back as 1981. Because a holder typically does not maintain records for such a lengthy period, unclaimed property audit liabilities are often determined using estimation methods and extrapolation. As a result, while a single year's actual unclaimed property liability may be immaterial, the total extrapolated liability determined using an estimation method frequently runs into the millions of dollars.

Loyalty Reward Cards are not Gift or Stored Value Cards

During an audit examination of a loyalty rewards card holder, states may attempt to treat uncashed loyalty rewards as unclaimed property by applying their gift and/or stored value card statutory provisions to loyalty reward cards. In addition to the important corporate domicile state, Delaware, a number of states treat unredeemed gift card and stored value card balances as unclaimed property, including the District of Columbia, Georgia, Nevada, New Jersey, New York and Texas.⁵ While some states may generally exempt unredeemed gift or stored value card balances from being unclaimed property, including Florida, Ohio and Virginia,⁶ others provide exemptions only if the cards carry no expiration dates, no dormancy or service charges, and are gift cards issued for merchandise. These states include California, Illinois and Tennessee.⁷

States may come to understand the distinction between loyalty reward cards and gift or stored value cards. Even New Jersey explicitly provides that its broad (and controversial) unclaimed property statute concerning gift and stored value cards does not apply to loyalty reward cards. Nonetheless, a holder of uncashed loyalty rewards should be prepared to show that its loyalty reward cards are not gift or stored value cards. Loyalty rewards programs are distinguishable.

A gift card is not a stored value card, per se, as the value is not stored on the card. Rather, the value associated with a gift card is stored on the issuer's database which is accessed via a magnetic strip or barcode on the card, a microprocessor chip in the card using radio frequency identification (RFID), or by use of a code entered into a numeric key pad. A true stored value card has its value held on the card, such as a public transit system farecard. A prepaid card is different still, as the value of the prepaid card is on deposit with the issuer (i.e., prefunded).

Gift cards are either open loop (i.e., issued by a bank or credit card company and can be used at any retailer or business) or closed loop cards (i.e., issued by a retailer or restaurant and the card can only be used at the establishment).

Mobile and virtual gift cards are becoming more common. Mobile gift cards are delivered to mobile phones via SMS messages using iPhone or Android "apps." Virtual gift cards are delivered via email to their recipient, who can print the card or open the card on a mobile device.

Are Unused Loyalty Rewards Unclaimed Property?

Just as states should not be able to rely on statutory provisions that treat unredeemed balances on gift or stored value cards as unclaimed property, a holder should similarly not be able to rely on gift or stored value card exemptions provided by other states. Therefore, if the customer does not redeem loyalty rewards within a state's dormancy period (typically three or five years after the card was issued), are the rewards reportable as unclaimed property?

As with yesteryear's gift certificates, a state would likely consider uncashed loyalty rewards as intangible, not tangible, property since the value is represented by the reward points and not the physical card.⁸ Section 1(13) of the 1995 Uniform Unclaimed Property Act defines "property" to include ". . . a fixed and certain interest in intangible property that is held, issued, or owed in the course of a holder's business . . ."⁹ Section 2 of the Act provides various dormancy periods for specific types of property to determine when they are presumed

abandoned and subject to reporting as unclaimed property. A catchall provision in Section 2(a)(15) provides that "all other property [is presumed abandoned], five years after the owner's right to demand the property or after the obligation to pay or distribute the property arises, whichever first occurs."

An owner is defined by Section 1(11) of the Act to mean ". . . a person who has a legal or equitable interest in property subject to this Act." Section 1(6) of the Act defines a holder to mean "a person obligated to hold for the account of, or deliver or pay to, the owner property that is subject to this Act." While not every state has enacted the Act (or has enacted one of its 1981, 1966, or 1954 predecessors), many states provide the same or similar statutory treatment of the issue.

An owner of a loyalty reward card has a right to demand products or services in exchange for his reward points, but not a cash equivalent value of the points on his card. Likewise, the holder has no obligation to pay a cash equivalent value to the owner; rather, the holder's obligation is to exchange a product or service, but only when the owner uses or redeems her or his points. Further, the owner has not offered cash or services in exchange for the card or rewards. The card is not prefunded. Therefore, the owner or customer has not given any monetary consideration in exchange for the loyalty reward. The underlying business transaction that caused the points to be generated should not count as monetary consideration because presumably the transaction was a fair exchange for goods or services at their market value.

However, Section 2(e) of the Act provides that "[p]roperty is payable or distributable . . . notwithstanding the owner's failure to make demand or present an instrument or document otherwise required to obtain payment." Could a state rely on this provision and the broad definition of "property" to argue that unused loyalty rewards are unclaimed property, regardless of the owner's inability to demand cash redemption or the absence of monetary consideration for the owner's loyalty reward?

A holder may need to rely on the derivative rights doctrine. That is, a state succeeds only to the rights an owner of unclaimed property has to or in the property that is presumed abandoned.¹⁰ Just as the owner has no right to cash equivalent of the loyalty reward, neither does the state have the authority to demand the cash equivalent. Still, the holder could be confronted by the no private escheat public policy that has prevailed in the other cases, including those involving gift certificates.

If loyalty rewards are reportable unclaimed property, what is the value to be reported? Like loyalty rewards cards, gift cards usually do not allow the owner to demand a cash equivalent of the face value or balance of a gift card. For this reason, state unclaimed property statutes provide that the amount of a gift card that is presumed abandoned is the face value, percentage of face value or the unredeemed balance.¹¹ Since loyalty reward cards are not gift or stored value cards, a state may not be able to rely on this provision. As a result, loyalty reward cards should have no reportable value.

Conclusion

The popularity of loyalty reward card programs for issuers and consumers make them a valuable marketing tool. This value, however, will likely not escape the attention of state unclaimed property administrators and auditors in this era of state budget shortfalls. Loyalty reward cards raise a number of questions for holders and states with respect to unclaimed property, including classification and valuation, among others. For these reasons, issuers of loyalty reward cards should be prepared to vigorously defend their rights in an unclaimed property audit examination while proactively addressing the treatment of their loyalty reward programs under state unclaimed property laws.

Mr. Smith is an attorney in our Washington, D.C. office.

1. *Media Post News Marketing Daily*, "Study: One-Third of Loyalty Rewards Uncashed" (April 19, 2011).
2. Property "escheats" to a state after it has become presumed abandoned or unclaimed when the state requires the holder to report and deliver the property or its cash value to the state for custodial holding until the owner establishes a rightful claim to the property.
3. *Texas v. New Jersey*, 379 U.S. 674 (1965); *Delaware v. New York*, 507 U.S. 490 (1993). If the state of corporate domicile does not escheat the property, some states then rely on a place of transaction to report the unclaimed property. This "third priority" rule is constitutionally suspect and rarely applied in practice.
4. For example, Maine, Nevada, New Jersey and Texas have adopted "deemed owner address" provisions. 33 M.R.S.A. § 1958(2)(B-1); Nev. Rev. Stat. § 120A.520(2); N.J.S.A. § 46:30B-42.1.c; Tex. Prop. Code § 72.1016(c).
5. 12 Del. Code § 1198(11); D.C. Code § 41-114; O.C.G.A. § 44-12-205; Nev. Rev. Stat. § 120A.520 (but reportable at 60 percent of unredeemed balances); N.J.S.A. § 46:30B-42.1; N.Y. APL § 1315; and Tex. Prop. Code § 72.1016.
6. Fla. Stat. § 717.1045, Ohio Rev. Code § 169.01(B)(2) (d); and Va. Code § 55-210.8.1.B.
7. Cal. Code Civ. Proc. § 1520.5; 765 I.L.C.S. § 1025/10.6; and T.C.A. § 66-29-135. Federal consumer protection law, the Credit Card Accountability Responsibility and Disclosure Act (CARD Act) and the Electronic Funds Transfer Act, 15 U.S.C. § 1693l-1(c), prohibit the sale or issuance of gift certificates or cards with expiration dates of less than five years. In the absence of unclaimed property statute prohibitions on expiration dates, some courts have held expiration dates violate public policy as a "private escheat." *Callahan v. Marshall Field & Co.*, 83 Ill. App. 3d 811 (1980); *Screen Actors Guild, Inc. v. Cory*, 91 Cal. App. 3d 111 (1979).
8. *Marshall Field & Co.*
9. The Act's definition of "property" includes, among other items, money, credit balances, credit memoranda and gift certificates.
10. *Bank of America National Trust and Savings Ass'n v. Cranston*, 252 Cal. App. 2d 208 (1967); *Violet v. Travelers Express Company, Inc.*, 502 A. 2d 347 (R.I. 1985); *Kane v. Insurance Company of North America*, 392 A. 2d 325 (Pa. Commw. 1978).
11. For example, Section 2(a)(7) provides that the amount of a gift certificate presumed abandoned is 60 percent of the face value. New Jersey provides that the "proceeds of a stored value card presumed abandoned shall be the value of the card, in money, on the date the stored value card is presumed abandoned." N.J.S.A. § 46:30B-42.1.b.