REPRINTED WITH PERMISSION. Copyright Thomson Reuters.

Note: Donna Wilson is partner, and John McGuinness is Counsel at BuckleySandler LLP, resident in the Los Angeles office (as of 2010).

Andrews Class Action Litigation Reporter
February 19, 2009

Commentary

SETTLING CLASS ACTIONS: ALTERNATIVES TO COUPON SETTLEMENTS AFTER CAFA AND CONSIDERATIONS FOR CORPORATE DEFENDANTS

Donna L. Wilson, Esq., John W. McGuinness, Esq., and Veronica D. Gray, Esq.

Copyright © 2009 Thomson Reuters

Donna L. Wilson, John W. McGuinness and Veronica D. Gray of Kelley Drye & Warren discuss the alternatives to coupon settlements following the Class Action Fairness Act's restrictions and the considerations corporate defendants must weigh when drafting a settlement.

Enactment of the Class Action Fairness Act arguably has led to more scrutiny by courts of so-called "coupon" settlements that provide coupons or discount certificates as the sole means of compensating class members. Pre-CAFA, these non-cash settlements had enabled defendants to settle, in particular, claims of dubious merit ("nuisance value" class actions) while avoiding long, drawn-out and costly litigation. Further, coupon settlements allowed defendants facing such class actions to minimize the effects of a settlement on their balance sheets, with relatively straightforward regulatory or accounting implications. [FN1]

Post-CAFA, courts and parties have increasingly turned to alternative forms of class compensation that are not coupons and are arguably "just like cash" but that enable the parties to settle nuisance-value and other claims that otherwise might be more difficult to settle on a cash-only basis and that would render CAFA's coupon provisions inapplicable. These new forms of settlement compensation are not without their own complications -- accounting implications, for example -- that corporate defendants should consider early in the settlement process.

CAFA's Restrictions on Coupon Settlements

When Congress passed CAFA, codified as 28 U.S.C. §§ 1332(d), 1453 and 1711-1715, it was well aware of the necessity of settlement for many defendants faced with class actions of questionable merit. [FN2] Nonetheless, Congress expressed concern that coupon settlements were being structured to benefit class counsel at the expense of the class members. Consequently, Congress enacted CAFA to "assure fair and prompt recovery for class members with legitimate claims." [FN3] Significantly, however, and contrary to some perceptions, CAFA did not prohibit coupon settlements. [FN4] Instead, it imposed such safeguards as requiring federal courts to hold a fairness hearing before approving a proposed coupon settlement, allowing courts to rely on expert testimony regarding the benefit of a proposed settlement to a class and requiring court approval of attorney fees in class settlements. [FN5]

In response to CAFA, parties and the courts have turned to other methods of class compensation in order to achieve what might otherwise be unachievable settlements. But before pursuing such alternative forms of compensation, defendants should consider their implications and exercise care in structuring such settlements.

Alternatives to Coupons Settlements

While CAFA does not define "coupon settlement," the meaning most commonly applied by courts and legal scholars is a settlement in which a plaintiff must spend money in order to realize the settlement benefit. [FN6] Alternative benefits that do not meet this definition have increasingly gained approval by the courts since CAFA. Ex-

© 2011 Thomson Reuters. No Claim to Orig. US Gov. Works.

amples of what may be considered an alternative, "just like cash" benefit include:

• Whole products or services that are not the subject of the lawsuit and are likely to be desirable to most class members;

• Gift cards good for the purchase of a whole product, not a portion of one, for any of several specified products or for any product in or below a certain price range;

• Mixed coupon/cash settlements, or giving class members the option of choosing between cash or a coupon or other non-cash benefit; and

• Equitable relief in cases where there have been no actual damages to the class members, aimed at addressing the wrong alleged in the complaint. [FN7]

Considerations of 'Just Like Cash,' Non-Coupon Settlements for Corporate Defendants

Alternative forms of "just like cash," non-coupon settlements raise at least three potential considerations for corporate defendants:

• The way in which such a settlement would be treated for accounting purposes;

• The risk of state escheatment if the card or benefit is not redeemed within the allotted time period; and

• The possibility of cash redemption.

Accounting for 'Just Like Cash,' Non-Coupon Settlements

The Securities and Exchange Commission has not taken a public position on gift card or merchandise certificate accounting, except to advise that the agency does not view immediate recognition of any amount of revenue at the point of sale as consistent with its view of generally accepted accounting principles." [FN8] Regardless of the accounting method, most companies have adopted a policy statement explaining the accounting method being used for their gift cards. Further, gift cards potentially can cause a company to carry a greater contingent liability compared to coupon settlements, at least in the short term. Coupons, by comparison, are typically accounted for as a contingent liability at the historical rate of redemption, however, they are typically also offset by an eventual increase in cash revenue when the coupon is redeemed. [FN9]

Generally, gift cards are accounted for at two points: when the card is sold/issued and when it either is used or expires (referred to as "breakage"). [FN10]

Outside the settlement context, when gift cards are sold or issued, companies either recognize actual revenue on their sale or, more frequently, record a deferred revenue liability (or unearned revenue liability) and increase in cash flow (the "delayed recognition" method). [FN11] In the context of a settlement, this deferred revenue liability will not have an offsetting increase in cash flow.

The delayed-recognition method generally works as follows:

• When gift cards are issued (sold), they are listed on the balance sheet as both deferred revenue and contingent liability; [FN12]

© 2011 Thomson Reuters. No Claim to Orig. US Gov. Works.

• When customers redeem the gift cards, the revenue is moved from deferred revenue to revenue and the contingent liability is reduced by that amount; [FN13] and

• With respect to unredeemed balances, companies may recognize the breakage (by moving the unredeemed amounts from deferred revenue to revenue) based on their historical redemption rates (generally a two-year period is required by most accounting firms). Once this historical experience with redemption is established, the gift card issuer can recognize the breakage as revenue based upon the estimated or historical redemption rate. [FN14]

In the gift card settlement context, given that the card is not being purchased, there is no revenue or deferred revenue for the corporate defendant to book. Instead, gift card settlements are only booked as a contingent liability based on the full value of the cards. [FN15] Over time, the contingent liability may decrease as gift cards are redeemed, as they expire or as breakage revenue is recognized for any remaining value of unused gift cards. However, in the short term the contingent liability might be far greater than in the coupon settlement context, where contingent liability is immediately booked at a reduced historical redemption rate. Thus, in effect, the corporate defendant's balance sheet likely will, in the short term, have greater exposure as a result of a gift card settlement. [FN16]

State Escheatment Laws

State escheatment laws trigger unclaimed property, such as the unclaimed value of a gift card, to be reverted to the government after a certain time period (the "abandonment" period). Although state laws on escheatment vary, they typically follow one of three models: [FN17]

• Model 1: No expiration, no escheat. The gift cards carry no expiration date and are redeemable by the cardholder indefinitely. Many states provide an exemption to escheatment for gift cards that do not impose an expiration date; [FN18]

• Model 2: 60/40. The gift card carries an expiration date and will escheat to the state after the abandonment period. However, only a percentage of the gift card (for example, 60 percent) will escheat to the state. This model acknowledges the costs to the retailer associated with maintaining the gift card and therefore allows the company to keep a predetermined percentage after expiration and the abandonment period; [FN19] and

• Model 3: No expiration date, escheatment laws apply. Connecticut, for example, prohibits expiration dates on gift cards, but unclaimed property still escheats after the statutory abandonment period. [FN20] Under this model, cardholders are expected to use their gift cards within the allotted time frame.

Model 1 prolongs the period that the gift card can be redeemed and thus potentially increases the total amount a defendant will ultimately pay in settlement. Models 2 and 3 create the risk of some, if not all, of the unclaimed gift card balances escheating to the state, even though, because of an expiration date, they would no longer be redeemable by the class members.

Properly structured, however, a settlement involving a form of gift card should not trigger state escheatment laws, regardless of the model. For example, many states' escheatment laws apply only to gift cards that are purchased for value by the consumer, which arguably is not the case in the settlement context. [FN21] However, all relevant state laws should be considered when entering into a "just like cash" alternative class benefit.

Optional Cash Redemption

In some states gift cards under a certain amount (for instance, $10 in California) may be redeemed for cash. [FN22] One way to avoid this is to settle under the condition that the gift cards, despite the remaining balance, cannot be redeemed for cash. However, it has yet to be tested in the courts whether such terms are enforceable. Again,

© 2011 Thomson Reuters. No Claim to Orig. US Gov. Works.

defendants should consult with counsel in structuring any "just like cash" settlement.

Conclusion

Although coupon settlements remain a viable option for corporate defendants after CAFA, to avoid the law's restrictions on such settlements, corporate defendants should consider gift cards and other alternative forms of settlements. However, these alternatives present accounting and other issues that should be weighed carefully before negotiating a settlement to avoid unintended consequences.

[FN1]. Further, regardless of the merit of the claims, settlement of class claims for a cash benefit to each class member can be impossible for many defendants. See Edward F. Sherman, *Class Actions After the Class Action Fairness Act of 2005*, 80 Tul. L. Rev. 1593, 1614 (2006) (noting that "coupon settlements are sometimes a necessary feature of a settlement," as "[a] defendant might be driven into bankruptcy if substantial cash damages are awarded, while coupons can provide class members with at least some benefit"). *See also In re Compact Disc Minimum Advertised Price Antitrust Litig.*, 292 F. Supp. 2d 184, 187 n.2 (D. Me. 2003) (noting, in approving coupon settlement, that plaintiffs benefited because it would have been impractical to distribute cash, and such a process would have made it hard to accurately calculate the actual loss suffered by each class plaintiff); *cf. Figueroa v. Sharper Image Corp.*, 517 F. Supp. 2d 1292, 1307, 1329 (S.D. Fla. 2007) (refusing to approve a settlement of a $19 store credit since, because of the cost of defendant's merchandise, it could not be used to purchase a whole product and therefore was not "fair, adequate, or reasonable" under CAFA).

[FN2]. *See* 109 S. Rep. 14, at 21 (2005) (noting that "[w]hen plaintiffs seek hundreds of millions of dollars in damages, basic economics can force a corporation to settle the suit, even if it is meritless and has only a 5 percent chance of success").

[FN3]. Pub. L. No. 109-2 (2005).

[FN4]. *Chavez v. Netflix Inc.*, 162 Cal. App. 4th 43 (Cal. Ct. App., 1st Dist. 2008) (holding CAFA does not prohibit all coupon settlements).

[FN5]. *See* 28 U.S.C. § 1712.

[FN6]. *See, e.g., Browning v. Yahoo Inc.*, No. C04-01463, 2007 WL 4105971, at *5 (N.D. Cal. Nov. 16, 2007) (in class action alleging that credit repair product was not advertised in accordance with Credit Repair Organization Act, settlement providing class members with free credit score or credit monitoring was not a coupon settlement because it "[did] not require class members to spend money in order to realize the settlement benefit"); *Perez v. Asurion Corp.*, No. 06-20734-CIV, 2007 WL 2591180, at *2 (S.D. Fla. Aug. 8, 2007) (holding that although the phone cards and vouchers were not cash, they also were not coupons because they did not require an additional purchase to be redeemed); *In re Wireless Tel. Fed. Cost Recovery Fees Litig.*, No. MDL 1559, 2004 WL 3671053, at *4 (W.D. Mo. 2004) (holding free cell phone minutes not a coupon because class members "[would] not be required to purchase any additional services or items" to receive the benefit).

[FN7]. While the forms of non-cash benefits described above are less likely to be considered "coupon settlements" and thus are not per se subject to CAFA, courts may subject such settlements to heightened scrutiny if they appear similar to coupon settlements. *See, e.g., Synfuel Tech. v. DHL Express (USA)*, 463 F.3d 646, 654 (7th Cir. 2005) (noting that although it was not bound by CAFA, the court looked to the law for guidance relating to settlement involving a pre-paid DHL envelope or a cash award for a value considerably less than the face value of the envelope and holding that, while the envelope was not a coupon, it shared some of the same characteristics of coupons); *Yeagley v. Wells Fargo & Co.*, No. C 05-03403 CRB, 2008 WL 171083, at *8 (N.D. Cal. 2008) (while noting that the free credit report was unlike a coupon in that it "[did] not require a class member to do business with Wells

© 2011 Thomson Reuters. No Claim to Orig. US Gov. Works.

Fargo and it entitles the class member to a whole product ... rather than merely a discount," holding nonetheless that CAFA was still "instructive").

[FN8]. Charles Owen Kile, *Accounting for Gift Cards*, J. Accountancy (November 2007), *available at* http://www.journalofaccountancy.com/Issues/2007/Nov/AccountingForGiftCards.htm.

[FN9]. *See* Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products), Fin. Accounting Standards Bd., EITF Issue No. 01-9, 14-15 (2001).

[FN10]. Robert Maden & Timothy B. Forsyth, *Gift Cards and Financial Reporting: Unwrapping the Uncertainties of Revenue Recognition and Other Issues*, CPA Journal (November 2007), *available at* http://www.nysscpa.org/cpajournal/2007/1107/essentials/p28.htm.

[FN11]. *Id.* at note 10; Kile, *supra* note 8.

[FN12]. *See* Kile, *supra* note 8.

[FN13]. *Id.*

[FN14]. *Id.*

[FN15]. For example, one national retailer indicates in its financial statements that gift cards older than 24 months are considered "unredeemed" and accounted for accordingly. *See* Maden, *supra* note 10.

[FN16]. Notably, however, upon settlement, the new contingent gift card liability would still be replacing any contingent liability that was forecasted for the litigation's potential settlement or in the event of an adverse judgment.

[FN17]. Kristin Arnold, *Expired Gift Cards: Whose Money Is It?*, Bankrate.com (Jan. 27, 2006), available at http://www.bankrate.com/brm/news/cc/20060127a1.asp.

[FN18]. *See, e.g.*, Cal. Civ. Proc. §§ 1510, 1747.45 (California escheatment law); 72 Pa. Cons. Stat. Ann. § 1301.6(1) (Pennsylvania); Tenn. Code Ann. § 66-29-101 (Tennessee); Wash. Rev. Code Ann. §§ 63-29.010, 19.240.005 (Washington).

[FN19]. Notably, certain states' escheatment laws combine these models. For instance, in North Carolina retailers must wait three years and then are allowed to keep 40 percent of the money on cards that have an expiration date; the other 60 percent goes to the state (Model 2). If the card has no expiration date, the retailer is allowed to keep all the money (Model 1). *See* N.C. Gen. Stat. § 116B-54.

[FN20]. Conn. Gen. Stat. §§ 3-67a, 42-460.

[FN21]. *See, e.g.*, Cal. Civ. Code § 1749.5(d)(1) (exempting gift certificates from escheatment "that are distributed by the issuer to a consumer pursuant to an awards, loyalty or promotional program without any money or other thing of value being given in exchange for the gift certificate by the consumer"); Va. Code Ann. § 55-210.8:1 (exempting "promotional incentives" from state escheatment laws).

[FN22]. *See* Cal. Civ. Code § 1749.5(b)(2).

© 2011 Thomson Reuters. No Claim to Orig. US Gov. Works.