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Consumer Rebates: State-Sponsored Feeding Frenzy Is Coming

by Robert Peters

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If your company offers rebates as part of its consumer marketing strategy, a new financial threat is coming over the horizon. Thanks to a recent court ruling, your firm could soon owe millions of dollars to one or more states.

The issue is uncashed rebate checks. Experts say U.S. companies offer between $4 billion and $10 billion in consumer rebates each year.[1] Although actual estimates are hard to come by, up to 40 percent of all rebates offered are never processed either because of failure on the part of the consumer to submit the necessary information or because of an error on the part of the rebate processor. More surprisingly, of the rebate checks that do get issued, anywhere from 6 percent to 10 percent are never cashed. Those uncashed checks or "slippage," as the term is used in the industry, have now come under scrutiny by an overwhelming majority of state unclaimed property administrators.

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In the last few years, budget-strapped states have begun to eye uncashed rebate checks as a source of revenue under unclaimed property (UP) laws. Regrettably, that focus by the states is just now catching the attention of the marketing and financial officers at most manufacturers and retailers that have responsibility over rebate programs that may have been in existence for 10 or more years.

Many companies have revised program rules to limit their exposure. Others have tried to structure outsourcing relationships to transfer liability. Some companies — such as Best Buy — have even changed the mechanism of their rebate program to ensure that there is no unpaid liability.

Unfortunately, recent developments in a significant lawsuit pose a serious threat to many rebate sponsors that rely on established industry practices to avoid liability. A January 2009 district court ruling in Iowa — the lead state in the rebate clash — has weakened many of those protective practices. As a result, state pressure on rebate sponsors is likely to increase. Manufacturers and retailers that fail to take proper precautions will become a target for the states or their contingent fee auditors who appear rifle-focused on a pervasive industry practice of "purported" noncompliance with the various state unclaimed property provisions.

Companies in the Crossfire

The rebate wrangle began in February 2006 when the Iowa state treasurer sued Young America Corp. for failure to report uncashed rebate checks and remit them to the state.[2] Most companies that offer rebates hire a third-party fulfillment company to receive consumer claims and issue checks, and Young America is among the largest of those firms. The action, which was joined by approximately 45 other states, sought damages of more than $120 million. The suit also named three of Young America's clients — Walgreens, Sprint, and T-Mobile.

In October 2008 the three client companies made summary motions for dismissal of the charges. All three pointed out that when their fulfillment company (Young America) issued a rebate check, the companies transmitted funds to the company equal to the value of the check. Young America never

[1]Matthew A. Edwards, "The Law, Marketing and Behavioral Economics of Consumer Rebates," *Stanford Journal of Law, Business & Finance*, 2007, vol. 12, p. 362.

[2]*Fitzgerald v. Young America Corp.*, CV 6030 (Iowa District Court, Feb. 8, 2006).

informed the merchants when a check was uncashed; provided names, addresses, or amounts of uncashed checks; or returned any money. Essentially, Walgreens, Sprint, and T-Mobile argued that since they were not in possession of the rebate money, they could not be held liable for failure to report and remit any uncashed rebate checks as unclaimed property.

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In January 2009 the court denied the rebate sponsors' motions for dismissal as well as the state's motion for a partial summary judgment against the three rebate sponsors.[3] The ruling did not address every issue directly, but only insofar as the issues affected whether the parties were entitled to summary judgment. However, within that context, the court did signal broad agreement with critical arguments that do not bode well for rebate sponsors.

Main Arguments

- The court found that under Iowa law the "holder" of unclaimed property is not limited to the party in possession of the property. The statute defines a holder as any person who is in possession of unclaimed property or who "is indebted to another on an obligation" for the property.[4]
- The court appeared to look favorably on the argument that unclaimed property is "the debt that is created by the rebate offer which creates the consumer's right to payment and the merchant's obligation to pay." Rebate sponsors are therefore normally the true holders of unclaimed property "because they are indebted to consumers on their rebate obligations."
- Related to that point, the court indicated a positive view of a New Jersey ruling[5] that the critical issue in UP liability is the "underlying obligation" and that transmitting payment responsibilities to intermediaries through contractual relationships does not change the status of the "ultimate obligor."

What the Ruling Means for Companies That Rely on Rebate Programs

The ruling affects rebate sponsors in two troubling ways.

Rebate sponsors cannot point the finger at their fulfillment vendor.

The major outcome of the Iowa ruling is that outsourcing rebate program fulfillment to a third party does not automatically protect a company from UP liability. In fact, the ruling undercuts many of the assumptions retailers and manufacturers have historically advanced as protection offered by third-party relationships.

First, delegating fulfillment does not transfer liability. The court strongly signaled that the liability for uncashed rebates belongs to the party with the underlying debt obligation — often, that obligation will be with the rebate sponsor. But do fulfillment contracts offer any kind of liability protection? The determining factor would be which party has agreed to be the obligor for the debt represented by the rebate check. Under most existing contracts between rebate sponsors and fulfillment companies, there is no reference to which party is considered the primary obligor to the consumer. In such cases, it is unlikely that the courts will accept that liability has transferred from the rebate sponsors to the fulfillment companies.

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Second, transmitting rebate funds to a fulfillment vendor does not discharge a rebate sponsor's compliance obligation. As reinforced in the ruling, holder status is not based on which party has the money. Even if the rebate vendor possesses the rebate funds, it is still the rebate sponsor's responsibility to comply with UP laws.

Recent Developments

There have been a series of new developments since the Iowa District Court decision this past January. Of considerable importance is the fact that the state of Iowa has separately settled out of court with two of the three "rebate sponsors," T-Mobile and Walgreens. As of the writing of this article, both Young America and Sprint are scheduled for trial, although the initial court date has again been pushed out until the spring of 2010.

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[3]*Fitzgerald v. Young America Corp. et al.*, CV 6030 (Iowa District Court, Jan. 5, 2009). Order at 14.

[4]Iowa Code section 556.1(5).

[5]*Clymer v. Summit Bancorp*, 726 A. 2d 983 (N.J. Super. Ct. Ch. Div. 1998), *rev'd*, 758 A. 2d. 652 (N.J. Super Ct. App. Div. 2000), *rev'd*, 792 A. 2d 396 (N.J. 2002).

On a related note, this past August, the state of Arkansas' Unclaimed Property Division filed suit against all three of the rebate sponsors, Sprint, T-Mobile, and Walgreens for failure to remit to the state uncashed rebate checks to payees located in Arkansas.[6] In addition to payment of the uncashed rebate checks, Arkansas is seeking interest and penalties as well as reimbursement of court costs from the named defendants. Noticeably absent from the suit is any mention of the fulfillment company, Young America, as being a named defendant. This signals a consistent theme reached in the earlier January 2009 Iowa decision that the rebate sponsors, as opposed to the fulfillment companies that process the rebate claims and physically issue the checks to the consumers, are being considered the parties liable for unclaimed property reporting. One can expect that the majority of other states that joined in the initial Iowa court action will follow similar suit in pursuit of the larger population of rebate sponsors throughout the country as opposed to the rather limited number of fulfillment companies that process the rebate offers.

The principal takeaway in most cases is that the responsibility for reporting and escheating uncashed rebate checks is squarely on the shoulders of the companies that offer the rebates. When state auditors come calling, companies likely will not be able to point the finger at their rebate fulfillment vendors.

Protective moves may be just cosmetic changes. The Iowa ruling also calls into question several mechanical devices that rebate sponsors have relied on for protection from UP liability.

For example, just about every consumer rebate check includes a "must cash by" date. Many companies put a great deal of stock in those deadlines, believing they relieve them of the responsibility for reporting unclaimed property. Although the Iowa court did not rule directly on that issue, it did spotlight the importance of the "underlying obligation" — not the mechanical instrument — of the rebate. Indeed, the majority of states have statutes that render void "private escheatment agreements," such as check expiration periods.[7]

Along the same lines, most rebate sponsors have created detailed rules for their rebate programs — meticulous requirements that consumers must fulfill before they will receive their rebate. Again, the recent ruling focuses squarely on the underlying debt. Against that fundamental obligation, program rules and regulations set out in rebate offers do not necessarily count for much.

The same principle applies to attempts to classify uncashed rebate checks as "fee revenue." This is a point of contention in the Iowa lawsuit. Did the defendants offer uncashed rebate checks as part of their compensation to Young America? The merchants deny it, but regardless of whether they did, the plaintiff is moving aggressively on that point. Again, state laws void private escheatment agreements. If anything, offering uncashed rebates as compensation demonstrates that the rebate sponsors have control over the rebate obligations.

Expiration dates, program rules, and creative classifications cannot protect companies from liability for uncashed rebate checks.

The emphasis on underlying obligation also casts doubt on some of the latest corporate efforts to guard rebate programs from UP liability. Recently, Best Buy began issuing rebates in the form of stored-value gift cards. Others have adopted bank debit cards as their rebate mechanism. The thinking is that those instruments facilitate a definitive transfer of the rebate money to the consumer. The fact, however, is that if those cards are never used, the underlying debt remains — and so does the UP liability.[8]

The principal takeaway is that check expiration dates, program rules, and creative classifications cannot protect companies from liability for uncashed rebate checks. Companies that rely on novel rebate mechanisms are on shaky ground.

It is important to understand that this case is not just local news. The Iowa unclaimed property statute is almost identical to the UP laws of every other state, so this decision affects retailers and manufacturers across the country. Most of the assumptions, planning, and actions they have relied on for years to protect them from rebate check liability are now useless.

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[6] Jim Wood, Arkansas State Auditor, Administrator of the Arkansas Unclaimed Property Law v. Sprint Spectum, L.P. , Mobile USA and Walgreen Co. , Circuit Court of Pulaski County, Arkansas 2nd Division.

[7] *See, for example*, Delaware sec. 1210, "No private escheats"; Colorado section 38-13-122, "Periods of limitations"; Michigan 567.223, "Unclaimed property held in ordinary course of business; presumption"; and Pennsylvania section 1301.2, "Property Subject to Custody and Control of the Commonwealth."

[8] As cited in the January 5, 2009, Iowa District Court ruling, "The proper focus is not what the instrument spelling out the evidence of property is called — whether a check, draft or anything else — but whether there is an underlying obligation, *i.e.*, whether there is unclaimed property." David J. Epstein, *Unclaimed Property Law & Reporting Forms*, section 12.02(2)(a)(i)(MB 2008).

What to Do Now

All this means one thing: Only a few obstacles now stand between the states and uncashed rebate checks potentially amounting to billions of dollars. What can companies that offer consumer rebates do to protect themselves from the coming feeding frenzy? I recommend action on three fronts.

Assess your company's past exposure. Begin with an inventory of your company's past and present rebate fulfillment agreements and identify personnel who are familiar with the firm's historical rebate activities. Determine your ability to access historic bank account records. Also, ascertain the UP filing history (if any) of your rebate fulfillment vendors. Next, evaluate your ability to credibly research outstanding rebate checks and match them with payees. Once you have your arms around the total population of data, assess your potential liability from untraceable rebate checks. Consider using statistical sampling techniques to develop a useful high-level estimate.

Consider 'best-case' options for resolving liabilities. Conducting this self-audit may feel like digging your own grave, but having more information provides you with valuable options for addressing potential state claims against rebate program liabilities. Many companies choose to initiate a voluntary agreement with key states. Others simply commence voluntary reporting and escheating of past and current obligations. Both options can result in the elimination of interest and penalties and limit the lookback period for state audits.

Plan now to prevent the problems from coming back. The first priority is to develop effective compliance processes. The key is designing standard operating procedures for tracking and, if necessary, reporting uncashed rebate checks and other forms of unclaimed property. Prospective planning should also be focused on restructuring your company's arrangements with rebate fulfillment companies. In light of the recent Iowa ruling, rebate sponsors should explore opportunities for contractually transferring UP obligations to third parties. Minimally, companies should tighten up their outsource contracts to make sure fulfillment vendors are actively complying with UP laws. Finally, companies should engage in transactional planning to control liability in the future. As with gift card programs, opportunities exist to structure rebate programs to minimize or mitigate your company's exposure.

One key point for all those actions is to actively involve the chief financial officer. Most of the rebate programs now under attack were initiated and implemented by corporate marketing departments, with little input from finance. CFOs are often taken by surprise when state auditors begin inquiring about uncashed rebate checks. Going forward, finance leaders must take an active role in all consumer rebate initiatives.

Forces Are Gathering

Now is the time to act on rebate program liabilities because forces are coming together that will create a significant problem for rebate sponsors.

In the recession, many companies are likely to increase their use of rebates as a proven driver of sales. At the same time, the economic downturn is exacerbating the state budget crisis — which will likely result in states redoubling their efforts to go after UP revenue. Yet increasing state pressure could force many rebate fulfillment companies to seek bankruptcy protection. In fact, several already have.

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In a worst-case scenario, some companies can end up paying rebate obligations *three times* — once when they transmit rebate funds to their fulfillment vendor, once when they issue checks to consumers (because their vendor went bankrupt), and once when they settle with state auditors for old liabilities "discovered" by extrapolation.

Retailers and manufacturers that offer rebates will have to act very carefully to fulfill their responsibilities without overcomplying. Despite the growing threat, the goal is still to meet, not exceed, unclaimed property requirements. ☆