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Law Commission

Consumer Prepayments on Retailer Insolvency

Law Com No 368

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Reforming the law

Consumer Prepayments on Retailer Insolvency

Law Com No 368

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The Law Commission

(LAW COM No 368)

CONSUMER PREPAYMENTS ON RETAILER INSOLVENCY

Presented to Parliament pursuant to section 3(2) of the Law Commissions Act 1965

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THE LAW COMMISSION

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The terms of this report were agreed on 14 June 2016.

The text of this report is available on the Law Commission's website at http://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/.

THE LAW COMMISSION

CONSUMER PREPAYMENTS ON RETAILER INSOLVENCY

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GLOSSARY OF TERMS

Administration	A rescue mechanism for insolvent companies, which allows them to continue their business temporarily.
Bond/bonding	A guarantee under which a third party undertakes to pay a sum of money if the retailer fails to fulfil its obligations.
Card issuer	An entity which issues credit or debit cards, such as a high street bank.
Card scheme	Payment networks, such as Visa and MasterCard, which facilitate card payment transactions.
Chargeback	The reversal of a card transaction which the consumer may ask their card issuer to request.
Consultation Paper	Law Commission, *Consumer Prepayments on Retailer Insolvency: A Consultation Paper* (June 2015) CP221. Available at http://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/.
Consumer	An individual acting for purposes that are wholly or mainly outside their trade, business, craft or profession, as defined in section 2(3) of the Consumer Rights Act 2015.
Creditor	An entity to which a person or company owes money or its equivalent.
Dividend	In this context, a payment made to the creditors of an insolvent company representing the whole, or a proportion, of the sum owed to them.
Fixed charge	A mortgage or a security over a specific asset to secure the repayment of a loan.
Floating charge	A security over a class of the company's assets or, more usually, over all of the company's assets, both present and future (for example, stock and money in bank accounts). On insolvency, the floating charge "crystallises" over the assets the company owns at that moment.
Insolvency	The status of a company when the value of its assets is less than the amount of its debts ("balance sheet insolvency") or it cannot pay its debts as they fall due ("cash flow insolvency").
Liquidation	A process through which a company is brought to an end. Its assets are sold and the proceeds distributed to the various creditors in accordance with the hierarchy set out in legislation.

Merchant acquirer	A bank which processes and receives funds for credit and debit card transactions.
Preferential creditor	A creditor who has a preferential right to payment before other creditors are paid.
Prepayment	Money, or goods for money's worth, provided to a person or company in advance of receiving goods or services. A prepayment could be for the entire balance, or just a proportion of the total price.
Secured creditor	A creditor which has a security interest, such as a fixed charge or floating charge, over all or some of the assets of the person or entity which owes it money.
Unsecured creditor	A creditor which is owed money but does not have the benefit of a security interest in the assets of the person or entity which owes it, or any degree of preference among fellow creditors.

TABLE OF ABBREVIATIONS

2EMD	2nd Electronic Money Directive
CCAS	Consumer Codes Approval Scheme
CTSI	Chartered Trading Standards Institute
EMR 2011	Electronic Money Regulations 2011
FOS	Financial Ombudsman Service
FCA	Financial Conduct Authority
OFT	Office of Fair Trading

ONLINE CONTENT

All websites and electronically available materials referenced in this document were last accessed on 30 June 2016.

THE LAW COMMISSION

CONSUMER PREPAYMENTS ON RETAILER INSOLVENCY

To the Right Honourable Michael Gove MP, Lord Chancellor and Secretary of State for Justice

CHAPTER 1
INTRODUCTION

1.1 Consumers often make "prepayments" to businesses, paying for goods and services in advance of receiving them. In the UK, online retail sales[1] and the gift card and voucher market[2] are booming, and consumers frequently pay in advance for products – from flights and theatre tickets to gym memberships and bathroom suites.

1.2 If the business that has taken the prepayment becomes insolvent, consumers may be left with neither the item they paid for, nor any real prospect of a refund. Insolvency law does not give consumers any special protection. Along with trade suppliers, landlords and many others, consumers are unsecured creditors who will not receive anything until secured creditors (typically banks and investment funds) and preferential creditors (such as employees) have been paid.

1.3 This does not mean that consumers always lose out. There are many ways in which consumers may be protected – through arrangements put in place by individual businesses, as a result of refunds available through credit and debit card issuers, or because of the commercial decisions taken by administrators. However, these arrangements are often voluntary rather than underpinned by legal rights.

1.4 Where consumers do suffer losses, they range from relatively modest amounts – perhaps a low value gift voucher – through to hundreds or even thousands of pounds, for example for furniture, home improvements or cars. In 2006, the collapse of savings club Farepak was particularly emotive as thousands of financially vulnerable consumers stood to lose nearly a year's worth of Christmas savings.

[1] According to the Office for National Statistics' Statistical Bulletin, *Retail Sales: February 2016* (available here), the amount spent online accounted for 13.1% of all retail spending (excluding automotive fuel) between 31 January 2015 and 27 February 2016.

[2] UK Gift Card & Voucher Association reported that in 2014 the market was worth £5.4 bn, split almost evenly between sales to consumers and sales to businesses: see *Gift Cards & Vouchers in the UK – Summary 2014*, available here.

TERMS OF REFERENCE

1.5 In September 2014, the Department for Business, Innovation and Skills (BIS) asked the Law Commission to examine the protections given to consumer prepayments and to consider whether such protections should be strengthened. Our terms of reference are as follows:

> This project is concerned with prepayments made by consumers to retailers and service providers. Prepayments are payments made in advance of receiving goods and services including, for example, gift vouchers, but not including bank deposits or damages for faulty goods.
>
> The Law Commission is asked:
>
> 1. To identify the existing protections given to prepaying consumers on the retailer's insolvency;
> 2. To consider whether such protection should be strengthened; and if so, what options are available for doing so;
> 3. To consult stakeholders; and
> 4. To make recommendations about which options, if any, should be pursued.

1.6 We have not been asked to draft legislation.

PREVIOUS REPORTS

1.7 Concern about consumer prepayments is far from new. The issues have been considered many times, though no legal reform has resulted.[3] Three themes emerge from previous reports.

Special protection on insolvency?

1.8 UK insolvency law is heavily influenced by the Cork Committee, which reported in 1982 and led to the Insolvency Act 1986.[4]

[3] For an outline of previous reports, see Law Commission, *Consumer Prepayments on Retailer Insolvency: A Consultation Paper* (June 2015) CP221 (the Consultation Paper), paras 1.22 to 1.56. Available here.

[4] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558.

1.9 The Committee believed strongly that all unsecured creditors should be treated equally. It had received complaints from members of the public who had paid in advance for goods and services and were left without a remedy on retailer insolvency.[5] It also noted media concern that the present law was unjust. It concluded, however, that this attitude was misguided. It saw "no essential difference" between prepaying consumers and trade customers who provide goods or services for which the insolvent business has yet to pay: each gives credit, and the Committee considered that each should bear the same proportion of the loss.[6] Furthermore, when consumers lost money they generally lost affordable sums – unlike some small businesses, for whom the retailer's insolvency may spell disaster.

1.10 By contrast, reports from the Office of Fair Trading (OFT)[7] and Consumer Focus[8] recommended that consumers should be given a preferential status on insolvency. They argued that consumers are less able than most other categories of creditor to assess the risk of a business failing, and that money taken from unsuspecting consumers should not be used to pay a company's other debts. However, both the OFT and Consumer Focus acknowledged that more data was needed to explore the effects of this proposed change, particularly on the cost of lending.

1.11 There is often public anger that repayment of banks and other secured lenders seems to absorb the vast majority of an insolvent business' assets, leaving little for consumers and other unsecured creditors. Secured lenders, unlike consumers, are generally in a position to monitor the viability of the business and to influence its approach to financial difficulties.

1.12 On the other hand, secured lending is critical to the operation of the retail market. In a few cases it may be appropriate to encourage lenders to be more cautious in lending to businesses which depend on significant consumer prepayments taken in cash. However, this must be balanced against the overwhelming need to keep lending affordable for viable businesses.

[5] Above, paras 1048 to 1056.

[6] Above, para 1052.

[7] See Director General of Fair Trading, *The Protection of Consumer Prepayments* (March 1986) and Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006).

[8] S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009).

Sector specific protection?

1.13 Trade bodies in particular sectors often encourage their members to take voluntary action to protect prepayments, by (for example) holding the money on trust or taking out insurance. As the OFT has acknowledged,[9] this is often problematic for businesses: putting money into trust deprives businesses of working capital, while insurance can be difficult to obtain.

1.14 There have been calls for protection of prepayments to be required through regulation (as well as suggestions that at least a meaningful threat of regulation would encourage more voluntary action). Both the OFT in 1984 and Consumer Focus in 2009 suggested that Parliament should grant powers to Government departments to regulate if necessary.[10]

Recourse through debit and credit card issuers

1.15 Consumers who pay by credit or debit card for undelivered goods and services may have recourse through their card issuer, which may agree to refund payments to consumers. These protections are of major importance to consumers in many situations, particularly following retailer insolvency. They are partly statutory (for credit card transactions of certain values, under section 75 of the Consumer Credit Act 1974) and partly voluntary (for both debit and credit card payments under "chargeback" arrangements).[11]

1.16 Consumer Focus suggested that the Government should consider introducing statutory protection for consumers who used debit cards.[12]

DATA ANALYSIS

Identifying the outcome for consumers in recent insolvencies

1.17 Over the years, there have been many notable cases where consumers lost out or risked losing out.

1.18 Since the 2008 recession, high street chains such as Borders, Comet, HMV, Republic and Zavvi went into administration with many gift cards and vouchers in circulation. In some cases, trading continued in administration and administrators allowed consumers to redeem vouchers. More recently, retailers BHS and Austin Reed entered administration during the preparation of this Report.

[9] Response for the OFT to the Department for Business, Innovation and Skills, Consumer Landscape Review (May 2011) para 9.16.

[10] Office of Fair Trading, *The Protection of Consumer Prepayments: A Discussion Paper* (October 1984) para 7.9 and S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009) p 39.

[11] These protections are introduced at para 2.7, and described in detail in Ch 7.

[12] S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009) p 40.

1.19 Deposits are particularly prevalent in the furniture, DIY and home improvements sectors. Here, a long list of retailers have encountered financial difficulties and entered administration, including World of Leather, MFI, Focus DIY, Habitat, Homeform, Dwell and Paul Simon. The amount of money taken by these companies in consumer prepayments was significant, and some cash buyers lost substantial sums. For example, when MFI went into liquidation, consumers had paid over £27.3 million in outstanding deposits. Consumers who had paid in cash were left without a remedy and suffered losses of around £8.5 million.

1.20 Following our reference from BIS, we analysed the outcomes in a sample of 20 large high street retailer insolvencies and 11 smaller retailers which occurred between 2008 and 2014. We gathered data available from public sources (mainly directors' statements of affairs and administrators' progress reports). We also spoke to several administrators to understand the nuances of how decisions were reached.

1.21 For a full account of our methodology and results, readers are referred to Chapter 3 of our Consultation Paper. In this Report, we use details from these sample cases to illustrate the nature of the problem, referring to specific high profile insolvencies, such as those of HMV or MFI.

Consumer experience case studies

1.22 In addition, Citizens Advice provided us with consumers' perspectives on retailer insolvency, identifying 810 cases involving consumer prepayments from bureau evidence forms and from calls to their Consumer Service.[13] They sent us an anonymised analysis of these cases which identified key themes, illustrated with case histories. The case histories provide a valuable insight into how retailer insolvency is perceived by consumers, and we quote from them throughout this Report.

THE CONSULTATION EXERCISE

1.23 We published a Consultation Paper in June 2015,[14] seeking views on provisional proposals. We received 41 responses to the Consultation Paper, from the following categories of respondent.

Insolvency Practitioners	13
Gift Voucher Sector	7
Consumer Interests/Protection	6
Academic	3
Card Scheme	3
Other	9
Total	*41*

[13] The Citizens Advice Consumer Service provides confidential and impartial advice on consumer issues. The case histories include calls to the service's predecessor, Consumer Direct.

[14] Law Commission, *Consumer Prepayments on Retailer Insolvency: A Consultation Paper* (June 2015) CP221.

1.24 In December 2015 we published a summary of consultees' views.[15] In Appendix A to this Report we provide a list of those who responded to the consultation together with a list of stakeholders we have met or otherwise corresponded with during this project.

1.25 We would like to thank all those who met with us or responded to the Consultation Paper and our other requests for information. We are extremely grateful for all contributions to this project.

THE SCOPE OF THIS PROJECT

Definitions

1.26 This project is concerned with what happens to consumer prepayments in the case of retailer insolvency. It is worth explaining what we mean by these terms.

Consumer

1.27 We look only at payments made by consumers, as defined in section 2(3) of the Consumer Rights Act 2015. We are therefore concerned with payments made by individuals "acting for purposes that are wholly or mainly outside [their] trade, business, craft or profession".

Prepayments

1.28 In this project, a 'prepayment' means a payment made by a consumers in advance of goods or services being provided. Consumers may pay fully in advance, pay a deposit or purchase a gift voucher for a friend or relative.

1.29 Consumers may have other claims against a retailer. They may, for example, be entitled to redress for faulty goods or may have been promised future benefits from loyalty cards or promotional vouchers. These do not fall within our terms of reference.

Retailers

1.30 In this project, we use the term "retailer" widely to cover all companies which provide goods and services to consumers, from hotels to builders, and from Christmas clubs to utilities companies.

1.31 We have not been asked to consider money paid to financial institutions, such as banks or insurance companies. Financial institutions are already heavily regulated, with complex schemes such as the Financial Services Compensation Scheme to protect consumers on insolvency.

[15] Available here. We made proposals and asked whether consultees agreed with each one. The options for response were "yes", "no" and "other", and in all cases we invited additional comments.

Insolvency

1.32 There are several reasons other than insolvency why a consumer who has paid money to a retailer may not receive the promised goods or services. The business may not be equipped to deal with the volume of orders it receives, or the directors of the business may have sought to defraud customers by taking consumer prepayments with no intention of fulfilling the orders. This project is not intended to deal with these situations.

1.33 We focus instead on the situation where the retailer becomes insolvent and is thus unable either to deliver goods or services or return the money.

1.34 Since almost all large and medium retailers and many small retailers trade as companies, rather than as individuals or as partnerships,[16] we deal only with the law affecting companies.

Geographical extent

1.35 The Law Commission can make recommendations only for England and Wales. However, the areas of law we consider in this project – consumer law and the relevant parts of insolvency law – are reserved. We hope that the Government will consider implementing our recommendations throughout the United Kingdom, after appropriate engagement with the devolved administrations. Large retailers operating in England and Wales also tend to have stores in Scotland and Northern Ireland, and we think that consumers would expect their rights to be consistent across the United Kingdom. It would be therefore be difficult to have differing levels of protection in each jurisdiction.

Terminology

1.36 In this Report, we refer to "gift vouchers", which are often a concern on retailer insolvency. For the sake of simplicity, we use this generic term to cover all forms of tokens, including paper vouchers, electronic cards and digital codes. We are particularly concerned with those cases where consumers have paid money up front for a voucher, either as a gift or as a form of prepayment.

1.37 Vouchers may also be bought by businesses. Examples include employers who use vouchers in reward schemes; insurance companies who provide vouchers rather than cash payments; or businesses who use vouchers in their promotions. We are not concerned with vouchers that are acquired in this way, though in practical terms it may be difficult to distinguish between those bought by individuals as gifts and those bought by businesses.

[16] Between March 2014 and March 2015, 94.3% of medium and large retailers (that is, those with 50 or more employees) traded as companies. Figures derived from Office for National Statistics, *UK Business: Activity, Size and Location, 2015*, dataset: UKBC -Enterprise/local units by Industry, Employment size band and Legal status. Available here.

THIS REPORT

1.38 The next two chapters outline the current position of consumers on retailer insolvency, in both law and practice. Chapter 2 looks at general retailers, while Chapter 3 focuses on the voluntary (and sometimes mandatory) schemes which exist in particular sectors. Chapter 4 then considers the need for reform.

1.39 The remaining five chapters set out a range of recommendations and options for reform:

(1) Chapter 5 focuses on the Farepak-style "savings" model. Although several Christmas savings schemes now protect prepayments through trust arrangements, some do not. We make a case for immediate regulation in this sector.

(2) Chapter 6 considers sector specific regulation more broadly. We recommend that the Government should have a power to require protection of consumer prepayments in any sector where the risk of consumer detriment justifies it. Although savings schemes are an immediate example of where sector specific regulation is needed, we think that the Government should have the ability to act promptly where other risks arise.

(3) Chapter 7 discusses the importance of the chargeback arrangements offered by credit and debit card issuers. We make practical recommendations to improve consumer awareness of, and access to, such protections. The card industry has agreed to take these plans forward.

(4) Chapter 8 considers a limited change to the statutory hierarchy governing how assets are distributed to creditors on insolvency. It would give preferential status to a small number of consumer claims, which would rank below employees' preferential claims but above claims from floating charge holders. We accept that any change to the insolvency hierarchy is a political decision for Government about where losses should lie and do not necessarily recommend immediate reform in this area. However, if the Government decides that a change is needed, we recommend that it considers this option.

(5) Chapter 9 looks at who owns goods which a consumer has paid for but has not yet taken possession of. The rules on this issue are particularly obscure. We recommend updated rules which are fairer and clearer.

1.40 These recommendations could be drawn on in whole or in part. We think that some recommendations, such as increasing consumer information about chargeback, should be implemented straight away. We also think that there is a very strong case for regulating Christmas clubs and similar "savings" schemes.

1.41 Other options, particularly the change to the insolvency hierarchy, are presented as options for the Government to consider if it has decided that it wishes to make a more fundamental policy move in favour of consumers.

1.42 Additional detail is included in the appendices:

(1) Appendix A contains a list of those stakeholders who responded to the consultation or have otherwise corresponded with us.

(2) Appendix B sets out the law on directors' liability, which does not feature in our recommendations for reform.

(3) Appendix C discusses those options considered in the Consultation Paper which we have decided not to pursue.

(4) Appendix D looks at the potential impact of our recommendations for law reform.

CHAPTER 2
CONSUMERS' POSITION ON GENERAL RETAILER INSOLVENCY

2.1 Insolvency law does not give consumers any special protection. When a company becomes insolvent, its remaining assets must be distributed to creditors according to a strict statutory hierarchy.[1] Most of the money will go to those towards the top of the list, such as employees and secured lenders, leaving very little for unsecured creditors such as consumers. Our analysis of insolvent retailers found that distributions to unsecured creditors tended to be derisory. If consumers have to rely on receiving a dividend as an unsecured creditor, the return may barely cover the cost of applying for it.

2.2 However, consumers are often protected in other ways. In particular:

(1) Consumers who have paid by credit or debit card may get a refund from the bank that issued the card. The bank may in turn raise a "chargeback" through payment schemes such as Visa and MasterCard.[2] We found that in practice the chargeback system is a major protection for consumers.

(2) On insolvency, most retailers enter a period of administration. An insolvency practitioner is appointed as administrator, and may be able to keep the business trading while working out the best way of dealing with it. As we explain below, the administrator may honour gift vouchers or fulfil customer orders during a period of trading in administration.

(3) Where the business is sold as a going concern, the subsequent purchaser of the business may choose to honour the prepayments.

(4) A consumer may already own goods for which they have prepaid. If so, the consumer would be entitled to claim possession of them on payment of any balance to the insolvency practitioner.

2.3 In this chapter we outline how and when these various protections work in the event of a business' insolvency, either to deliver the goods or services paid for by consumers or to refund the payments.

2.4 In the next chapter we consider the various ways a company may act to protect prepayments while it is still trading, usually by taking out insurance or a bond or by placing the prepayments in a ring-fenced trust account. This is rare in the general retail market, but common in some specific sectors, such as solar panels or double glazing. For package travel it is a legal requirement.

1 See from para 2.7 below, and Ch 7.

2 These are the main two card schemes, though there are others such as American Express.

DATA SOURCES

2.5 To illustrate how the law works in practice we draw on the analysis we prepared for the Consultation Paper. This is based on two samples of retailers who became insolvent between 2008 and 2014. The first sample looked at 20 large (or high street) retailer insolvencies which attracted press coverage because of the effect or potential effect on consumers. The second looked at 11 smaller retailers.[3] These provide many examples of how the law works in practice.

2.6 In Chapter 2 of the Consultation Paper we provided a full account of the law and in Chapter 3 described the research we carried out. We do not repeat these here. For this detail, readers are referred to the Consultation Paper.

REFUNDS FROM THE CREDIT OR DEBIT CARD ISSUER

2.7 Consumers who pay by debit or credit card for items which are not delivered may be entitled to a refund through the bank which issued their card.

2.8 In the case of a purchase by credit card for more than £100 and less than £30,000, the consumer has a statutory right to claim against the credit card provider under section 75 of the Consumer Credit Act 1974. This section applies generally, not just on the retailer's insolvency, and gives the consumer substantial rights. It is not limited to recovering the payment that has been made. Instead, the consumer may seek damages from the credit card provider for a breach of contract or misrepresentation claim which the consumer could also make against the retailer.

2.9 For other claims – that is for any purchases made by debit card, and for credit card purchases outside of the section 75 limits – consumers may be able to request a "chargeback" from their card issuer. If a consumer contacts the card issuer in sufficient time, and explains that the goods or services were not delivered, the issuer will usually refund the amount paid. The card issuer may then use the card scheme's "chargeback" rules to seek a refund from the merchant acquirer (that is, the party in the credit card cycle which processes card payments for the retailer).[4] Merchant acquirers are well aware of their liability to reimburse the card issuer for section 75 and chargeback claims, and will often hold back money from retailers to cover this liability.

2.10 In practice, the combination of section 75 and the chargeback rules provide extremely important protection for consumers. The amounts refunded in this way can be substantial. Available figures include MFI (£19.3 million); Homeform (£2.6 million); and Land of Leather (£1.1 million).

2.11 The main problem with chargeback is that consumers are not always aware of it, which means that this protection is not always fully used. In Chapter 7 we discuss the details of chargeback arrangements and set out recommendations for making the scheme more transparent.

[3] The retailers had become insolvent between 2008 and 2014. We drew data from publicly available documents filed at Companies House and in some cases talked to the insolvency practitioners to gain an understanding of how decisions were reached.

[4] The role of the merchant acquirer is explained in Ch 7, particularly para 7.3(4).

ADMINISTRATORS' DECISIONS ON CONSUMER PREPAYMENTS

2.12 Administration is a short term measure: an outsider (an insolvency practitioner acting as an administrator) steps in to see if the insolvent company can be saved, or at least sold as a going concern, rather than simply wound up.[5] Administrators' powers are set out in statute, and focus on one of three objectives:

(1) To rescue the company as a going concern;

(2) To achieve a better result for the company's creditors as a whole than would be likely if the company were wound up; or

(3) To realise property in order to make a distribution to one or more secured or preferential creditors. [6]

2.13 It is rare for administrators to achieve the first objective.[7] Instead, most administrators aim to secure a better result for the creditors by selling the business. In practice, the focus is often on preserving goodwill, in the hope of selling all or some of the business as a going concern – or at least preserving some value in the brand, so that the name and trademarks can be sold.

2.14 Administrators have a broad discretion to do anything "necessary or expedient" to achieve the relevant objective. However, administrators must perform their functions in the interests of the company's creditors as a whole.[8] They are not permitted to favour some creditors (such as consumers) over others.

Trading in administration

2.15 Administrators may decide to continue trading in administration.[9] The reasons are usually to enable surplus stock to be sold to consumers at higher prices or because a business which is still trading is more attractive to a potential purchaser. At least 13 of the 20 high street retailers we looked at traded in administration, typically for periods of six weeks to two months. In some cases, such as Game, some stores were closed while others traded.

2.16 During a period of trading in administration, administrators may honour gift vouchers or deliver prepaid goods. Administrators have the power to do this, but only if it would help achieve a better result for the company's creditors as a whole. The decision is a commercial one.

[5] It is normally limited to a year, but may be extended by the court at the request of the administrator: Insolvency Act 1986, sch B1, para 76.

[6] Insolvency Act 1986, sch B1, para 3(1).

[7] One 2006 study found that less than 10% of administrations rescued the company as a going concern: A Katz and M Mumford for the Insolvency Service, *Study of Administration Cases: Report to the Insolvency Service* (October 2006) p 34.

[8] Insolvency Act 1986, sch B1, para 3(2).

[9] Under para 14 of sch 1 to sch B1 of the Insolvency Act 1986, the administrator has a "power to carry on the business of the company".

Decisions about gift vouchers

2.17 There are two main reasons why honouring vouchers may benefit creditors as a whole. First, it will preserve value in the brand, which can then be sold to a new purchaser at a higher price. Administrators emphasised that well-known brands have significant commercial value which can erode quickly following complaints in the press and on social media that consumers have lost out.

2.18 Honouring gift vouchers may also bring people into stores. There may be "up-spend": that is, consumers may spend more than the voucher is worth. Where vouchers tend to be of low value and average spend tends to be high, this might lead to a profit. Alternatively, administrators may require consumers to spend money as a condition of voucher redemption: in Borders, for example, the administrators would only accept vouchers if the consumer made purchases of double their value. Recently, the BHS administrators reached a similar decision.[10]

2.19 On the other hand, honouring vouchers may be expensive, especially where stock is subject to suppliers' retention of title claims or sold at very low margins. VAT is also an issue. If a customer spends a £100 voucher on a £100 item, the administrator is required to pay VAT of £16.67 to HMRC, leading to a net outflow of funds from the business.[11]

2.20 Before making a decision, administrators need to look carefully at the figures. This will take a few days, during which there will be uncertainty. Administrators told us that it may be difficult to know exactly how many vouchers are in circulation. During normal trading, retailers estimate redemption rates: some vouchers will be written off on the ground that they will never be redeemed ("breakage"). However, these estimates may not apply during administration. If consumers know they only have a limited time to redeem vouchers, they may dig old ones out of the bottoms of drawers, resulting in a higher redemption rate than that estimated in the company's accounts.

2.21 Another consideration is the amount of "free stock" - that is, stock which the administrator is free to sell, without retention of title claims from suppliers. One administrator pointed out that the stock must also be in the same geographic location as the vouchers. However, the location where gift vouchers are purchased will not always be indicative of the location where they will be redeemed: one of their selling points is that they can easily be sent to friends and relatives in other parts of the country.

Decisions to fulfil orders

2.22 In some cases, consumers have paid for goods (either in whole or in part) which have not been delivered when the retailer becomes insolvent. This issue arises commonly in the furniture and home improvement sector (including kitchen and bathroom suites as well as furniture such as sofas).

[10] 'BHS vouchers can only be used for 50pc of purchases following firm's collapse', *Telegraph* (26 April 2016). Available here.

[11] Although any amount owed to HMRC in respect of VAT prior to the appointment of the administrations ranks as an unsecured claim in the administration, any VAT liability incurred during a period of trading in administration must be paid as an expense of the administration: https://www.gov.uk/insolvency-and-your-vat.

2.23 Many of the insolvent retailers in our samples operated in these sectors: eight out of the 20 large retailers, and six of the 11 small firms, sold furniture or operated in the home improvement sector. These sectors rely heavily on deposits as a source of working capital to fund supply. Goods are typically manufactured overseas and shipped to fulfil specific orders.

2.24 As with gift vouchers, administrators have to weigh the benefits of maintaining brand value against the availability of stock. However, deposits are often more problematic. First, furniture retailers may find it more difficult to trade while in administration. Items may still be held at customs, subject to retention of title claims, or held by carriers who exercise liens and refuse to release the goods. Suppliers may also refuse to deal with the company unless existing debts are paid.

2.25 It is easier to fulfil orders subject to small deposits than those subject to larger ones. Where a prepayment is relatively small, the administrator may make a profit from delivering the goods and receiving payment of the balance, thereby both extinguishing the unsecured claim and increasing the assets available to creditors as a whole. However, this would not apply to large prepayments where consumers stand to lose the most. For example, where the consumer has paid a 75% deposit, it is unlikely that the 25% outstanding will cover the cost of supply, delivery and VAT. And where the consumer has paid the full value of the pre-ordered item – a 100% deposit – then administrators would find it difficult to show any benefit to creditors as a whole.

Funding from merchant acquirers through the "chargeback chain"

2.26 As we discuss in Chapter 7, merchant acquirers will often hold back funds ("collateral") from the retailer against potential chargeback liability.[12] The more orders that can be fulfilled, the fewer chargeback claims are likely to be raised - and fulfilling orders is sometimes less costly than refunding deposits. Merchant acquirers may decide to fund the order completion process so as to reduce the amount of money required to meet chargeback claims.

2.27 This occurred in the case of Habitat, where most orders were funded by the merchant acquirer, whose chargeback liability would have exceeded the cost of completing the orders. In Focus DIY, the merchant acquirer faced a potential 10,000 claims with a total value of £3 million. Funding the completion of orders reduced this liability to £1.8 million.

DECISIONS BY PURCHASERS OF THE INSOLVENT BUSINESS

2.28 Purchasers of insolvent businesses will also face decisions about whether to honour gift vouchers and/or consumer deposits on pre-ordered items. Like administrators, purchasers may have a strong interest in maintaining consumer goodwill and brand value and they will wish to encourage people to continue to visit stores. Unlike administrators, new purchasers are not restrained by legal duties to other creditors. They therefore have more flexibility to make their own decisions on purely commercial grounds.

[12] The decision of merchant acquirers to retain funds is discussed at para 7.14.

2.29 For example, the purchaser of Dreams accepted liability for all existing customer orders (nearly 30,000 orders, for which customers had paid deposits totalling about £11 million). As any remaining unsecured creditors received less than 0.1 pence in the pound, this made a significant difference to the outcome for prepaying consumers.

2.30 Dwell had outstanding orders of £6 million at the date of the administrators' appointment, all of which had been fully paid for. The purchaser promised "to try" and resolve customer orders despite "not being legally obliged to", in order to "help customers and suppliers regain their trust in the Dwell brand".[13] Dwell offered customers alternative products for immediate delivery if the item ordered was not in stock. If an alternative could not be found, the company offered a gift voucher equal to the value of the order to customers who had paid by cash or could otherwise not claim chargeback.

2.31 However, maintaining the value of a brand is less important where the intention is to subsume the insolvent business into the buyer's existing brand. This may have been one of the reasons behind Sports Direct's refusal to honour gift vouchers when it bought JJB Sports (which was subsumed into the existing Sports Direct brand) and, later, Republic (soon subsumed into another of Sports Direct's brands, USC Clothing).

OWNERSHIP OF GOODS

2.32 A consumer may have acquired ownership of goods they have paid for even if the business is still in possession of those goods. If so, the goods will not form part of the business' general asset pool. Instead, they must be made available to the consumer rather than resold by the insolvency practitioner for the benefit of the creditors as a whole.

2.33 However, the issue of when ownership is transferred from retailer to consumer is governed by complex statutory rules, which are difficult for both consumers and insolvency practitioners to understand. We look at these rules in more detail in Chapter 9 and make recommendations for change.

THE EFFECT OF RETAILER INSOLVENCY IN PRACTICE

2.34 One reason for conducting our survey of high street insolvencies was to see how these complex decisions made by businesses, administrators and subsequent purchasers impacted on consumers.

2.35 Our analysis revealed two problem sectors: gift cards and vouchers (which we refer to generically as vouchers) and deposits made for furniture and other home improvements (such as furnishings, kitchens and bathrooms). We look at each in turn.

[13] 'Furniture retailer Dwell to reopen', *BBC News Online* (3 July 2013). Available here.

Gift vouchers

2.36 Gift vouchers were an issue in 15 out of the 20 large insolvencies we looked at. The total value of vouchers in circulation can be substantial: for example, HMV had £6.5 million in circulation, and Comet had £4.7 million. The number of vouchers in circulation can also be high: nearly half a million in both the Zavvi and Borders administrations.

2.37 However, consumer losses were not as prevalent as might appear. As shown in Table 1, gift vouchers were honoured to 100% of their value during a period of trading in administration or by subsequent purchasers in seven of the fifteen cases. HMV's administrators initially decided that gift vouchers would not be honoured but this decision was reversed in the wake of media and public protest. In a further two cases, gift vouchers were accepted but only as part payment. As we have seen, in Borders, consumers were required to spend double the value of their gift voucher.

2.38 In the remaining six cases, gift vouchers were not honoured - either because there was no period of trading in administration (Jessops), it was not commercially viable to do so (Zavvi), or because new purchasers were found at an early stage and they decided not to honour the vouchers (Republic, JBB Sports, La Senza and Peacocks).

Table 1: Treatment of gift vouchers by administrators and/or purchasers of 15 insolvent retailers

Accepted in full	7 retailers	Comet, HMV, Game, Habitat, Focus DIY, Blockbuster, Dreams
Accepted in part	2 retailers	Borders, Woolworths
Not accepted	6 retailers	Zavvi, Jessops, La Senza, Peacocks, Republic, JJB Sports

Gift vouchers and the use of trusts

2.39 It is possible for retailers to ring-fence consumer prepayments by placing them in a trust. This means that, on insolvency, the money still belongs to the prepaying consumers rather than creditors as a whole. In a 1975 case, *Re Kayford Ltd*,[14] the High Court confirmed that companies which are still trading can protect consumer prepayments by putting them into a separate trust account. However, they are under no obligation to do so.[15]

[14] [1975] 1 WLR 279.

[15] This point was emphasised in *Twinsectra v Yardley* [2002] 2 AC 164 at [73].

2.40 In Chapter 3 we look at some specific sectors in which businesses place money in trust as a permanent feature of their business model. None of the high street retailers we looked at used trusts in this way. However, in a few cases, the directors had set up a trust in the last days or weeks of trading due to concerns about insolvency. Directors may do this to avoid any perception that they have continued to take prepayments despite knowing that the company's financial difficulties might mean that the prepayments will not be honoured. On the other hand, directors may feel that to cut off this cash flow stream – and to shoulder the cost of trust arrangements – may ultimately be the tipping point which forces the company into insolvency. In addition, in most cases it is only with hindsight that it is possible to identify the point at which the company's insolvency was all but inevitable.[16]

2.41 Where directors do set up a trust in the run up to insolvency, this is of real benefit to the consumers who make prepayments after the arrangements are put in place. The directors of Zavvi set up a trust for the proceeds of sales of vouchers one month before entering administration. Those who claimed on the trust fund received a full refund, and the unclaimed funds were eventually released to the general body of creditors.

The overall extent of loss

2.42 As far as we have been able to estimate, losses totalling over £7 million were suffered by consumers in the six cases in which vouchers were not honoured. In other words, over £7 million of vouchers in circulation were rendered worthless (though some may not have been redeemed in any event).

2.43 There is an element of chance in this outcome. There is nothing in law to prevent significant losses to individual consumers where a retailer sells vouchers of a high value and has little free stock to trade while in administration. However, in the Consultation Paper, we commented that the overall effect appeared moderate rather than severe. Often the loss to each consumer was low. For example, in the case of Zavvi, although the vouchers had a combined value of £4.1 million, the average loss per consumer was only £8.12.

Deposits held by retailers in the furniture and home improvement sectors

2.44 Many of the largest losses concerned deposits for furniture, bathrooms and fitted kitchens. Table 2 below sets out the value of consumer prepayments held by some of these retailers at the point of insolvency.

2.45 Not all of these prepayments were lost. Some orders were fulfilled during a period of trading in administration (though these tended to be those where only a small deposit had been taken). Others were fulfilled by new buyers of the business. As we have seen, in both Dreams and Dwell, the purchasers undertook to fulfil orders.

[16] In Apx B, we discuss the various ways in which directors can be held liable where their conduct is found to have been inappropriate.

2.46 Crucially, consumers who had paid by credit or debit card were able to request a refund from the bank which issued the card. As we discuss in Chapter 7, the chargeback arrangements have prevented or mitigated millions of pounds worth of consumer losses.

2.47 The heaviest losses fell on consumers who had paid by cash or cheque. Consumers paying by these methods tend to be drawn from less well-off socio-economic groups.[17] Although only some figures are available, these "cash buyers" lost around £8.5 million in the MFI insolvency and £1.5 million in Homeform. An analysis of case histories provided by Citizens Advice suggested that the average amount lost in the cases reported to them was around £700.

Table 2: Estimates of consumer deposits held at time of insolvency

Date	Retailer	Estimate of consumer deposits held at time of insolvency
2008	MFI	£27.3 million
2009	Land of Leather	£3.5 million
2011	Homeform	£5.6 million
2011	Focus DIY	£3.0 million
2013	Dreams	£11.8 million
2013	Dwell	£6.0 million
2014	Paul Simon	£2.4 million

Distribution on liquidation

2.48 Consumers are classified as "unsecured creditors". Where consumers are left to rely on a distribution of remaining assets on liquidation, they will therefore find themselves towards the bottom of the insolvency hierarchy.

2.49 In Chapter 8, we describe the insolvency hierarchy in more detail and draw on our research to illustrate its effect. In the large retailer insolvencies we looked at, the expenses of the administration and employees were paid in full. Any remaining assets are then given to banks and other lenders who have taken floating charges over the company's assets. Very little money tends to be left over, and that has to be distributed across a wide range of creditors, in equal proportions.

2.50 The average distribution to unsecured creditors is small – often negligible. For example, in JJB Sports, the distribution was 0.34 pence in the pound, meaning that a consumer with a £100 claim would receive 34p. In many cases, the amount available will be barely worth the cost of claiming it.

[17] S Brooker for Consumer Focus, *Pay now, pay later: consumer prepayments and how to protect them* (August 2009) p 14.

CONCLUSION

2.51 The level of consumer detriment caused by retailer insolvency is low compared to more common problems, such as faulty goods or misleading statements. For example, Consumer Focus estimated in 2009 that consumers had lost around £133.3 million of prepayments in the last two years, though only some of these losses were caused by retailer insolvency.[18] This compares to its estimate of £3 *billion* for the detriment caused by unfair commercial practices.[19]

2.52 In practice, consumers are often protected through the voluntary actions of credit and debit card providers, administrators and business purchasers. In Chapter 3 we examine the ways in which businesses in some sectors may also act voluntarily to protect prepayments from consumers.

2.53 However, where these voluntary protections are not offered, consumers have few legal rights. As unsecured creditors, consumers are likely to receive only a negligible distribution on liquidation. As we discuss in Chapter 4, in a small minority of cases consumers can be left with significant losses - and may, not unreasonably, struggle to understand why the money they have paid in good faith will not be returned.

[18] See above. We discuss the methodological problems in estimating total losses in the Consultation Paper at paras 8.2 to 8.4.

[19] Consumer Focus, *Waiting to be heard: Giving consumers the right of redress over Unfair Commercial Practices* (2008).

CHAPTER 3
CURRENT SECTOR-SPECIFIC PROTECTION

3.1 For the last 40 years, Government has encouraged retailers to set up self-regulatory codes, offering consumers greater protection than the law requires. These have often been seen as the way to safeguard consumer prepayments on insolvency. The Office of Fair Trading (OFT) said that the solution to protecting prepayments was "the evolutionary development of schemes designed to cover particular problem areas", though it added that statutory powers may be required where voluntary action was not forthcoming.[1]

3.2 At present, the Chartered Trading Standards Institute runs the Consumer Code Approval Scheme whereby codes developed by trade bodies are subjected to a stringent approval process. One of the eight core criteria which qualifying codes must meet is that deposits or prepayments are protected. Prepayment protection is also to be found in some other voluntary codes. In a few sectors, lawmakers have intervened to make protection of prepayments mandatory – most notably for parts of the travel industry and for prepaid funerals.

3.3 In this chapter, we start by describing the ways in which businesses may act to protect consumer prepayments in the course of their business. We then look at examples of how these forms of protection have been used in voluntary codes and in mandatory schemes. We conclude that voluntary schemes are often valuable, but there are limits to what voluntary action can achieve. Businesses often find prepayment protection onerous: good traders who abide by codes are at risk of being undercut by those who do not.

METHODS OF PROTECTION

3.4 There are three main ways in which a business may protect consumer prepayments: trusts, insurance and bonds.

Trusts

3.5 It is possible for retailers to ring-fence consumer prepayments by placing them in a trust.[2] Where a trust is established, consumers are said to have a "beneficial interest" in the money. This means that, on insolvency, the prepaid funds still belong to the prepaying consumers rather than the business. The money does not form part of the company's assets so it is not distributed to creditors generally. Instead, if there are sufficient funds in the trust, consumers will receive their money back in full or, if there are insufficient funds to satisfy all claims, a pro rata payment.

[1] OFT, *The Protection of Consumer Prepayments: A Discussion Paper* (1984), para 7.9.

[2] In *Re Kayford Ltd* [1975] 1 WLR 279, the court confirmed that companies which are still trading can protect consumer prepayments by putting them into a separate trust account, but are under no obligation to do so. This point was emphasised in *Twinsectra v Yardley* [2002] 2 AC 164 at [73].

3.6 In the Consultation Paper we commented that putting consumer prepayments into trust can be an effective form of protection. However, trusts may be burdensome for businesses. Most importantly, the money must be kept separately and not used for other purposes. A trust therefore prevents the business from using the prepayments as working capital, for example to fund the supply of goods (as is common among furniture retailers). Trusts also involve upfront legal costs and additional administration on a day-to-day basis. There is a risk that if a trust lacks the correct legal formalities, administrators may seek to defeat it in the interests of creditors as a whole.[3]

Insurance

3.7 An alternative protection mechanism is for the business to arrange insurance to protect prepayments in the event of insolvency. In the Consultation Paper we commented that the market for prepayment protection insurance appeared to be underdeveloped in the general retailer context.[4] While it could be used for gift vouchers or deposits, only a few insurers offered it.

3.8 Insurance cover is commonly provided in some sectors, such as to buyers of new build properties, solar panels and double glazing. In other sectors, insurance may be difficult to obtain, expensive and hedged with exclusions and conditions. A further barrier is that any single retailer seeking deposit insurance in the absence of regulation or a voluntary code requiring it to do so is likely to be treated with suspicion.

3.9 When we consulted on the insurance market for deposit protection, two brokers (Chimera and Correlation Risk Partners) thought that we had been too negative. They told us that insurance was already used to good effect in particular sectors and that it would be available in others if requested. They felt that the main problem was lack of demand: although a single business would find insurance difficult to obtain, a trade body might be more effective in encouraging the insurance market to develop affordable products.

Bonds

3.10 Bonds are commonly used in the travel industry. The Association of Travel Agents (ABTA) requires new members to lodge a bond of at least £40,000 or 15% of turnover (whichever is the greater).[5] Most members obtain a bond from their bank, though some insurance companies also provide them. The bond provider guarantees to pay the agreed sum should the member become insolvent. The actual cost of the bond is defined by the market, and may vary from 1% to 12% of the bond's value depending on the retailer's risk profile.

[3] This was the case for one of the smaller retailers which we looked at, Foster Designs. It appears that a failure to implement proper trust arrangements led to nearly £30,000 of consumer deposits held in a designated client account being transferred to the liquidation estate.

[4] See Consultation Paper, Ch 10.

[5] For those with a good risk record, this will reduce to 10% over time. See Consultation Paper, Ch 10.

3.11 However, the bond may not be sufficient to cover an insolvency at the height of the holiday season. ABTA therefore provides further insurance cover through its own captive insurance company for which its members pay an additional premium.[6]

CCAS SCHEMES

3.12 Under the Fair Trading Act 1973, the OFT was mandated to encourage the growth of trade association codes of practice. This duty has since gone through many forms. In 2001, the OFT set up the Consumer Code Approval Scheme (CCAS) under which codes were developed by trade bodies and then subjected to a stringent approval process. In 2013 responsibility for CCAS, and in particular for granting approval for codes, was transferred to what is now the Chartered Trading Standards Institute.

3.13 At the time of writing there are 18 CCAS codes, to which over 32,000 businesses have signed up voluntarily.[7] Codes must meet a set of core criteria, including addressing the "protection of client's money, deposits or prepayments as appropriate".[8] Prepayments are simply one issue among many: other issues (such as dispute resolution) may well be more important to consumers. However, prepayment protection may prove a particularly onerous requirement for businesses because of the costs involved.[9]

Examples of prepayment protection in CCAS codes

3.14 The Consultation Paper included a detailed analysis of the prepayment protection provisions in 14 CCAS codes.[10] Here we use some examples to highlight the range of possible methods of protection.

3.15 Several of the codes do not specify the form that such protection must take. Instead they allow individual members to choose one of several methods, of which trusts are often the most popular. For example, the Institute of Professional Willwriters requires members who take deposits to show they are using "one of five approved methods of prepayment protection, such as a client account or participation in the Institute's payment protection scheme".[11]

3.16 A few CCAS codes offer insurance schemes. For example, the Renewable Energy Assurance Scheme extended the insurance arrangements it had previously used for warranties to cover deposits as well.[12]

[6] For further discussion see Consultation Paper, Apx D.

[7] http://www.tradingstandards.uk/advice/Currentcodesponsors.cfm.

[8] Chartered Trading Standards Institute, *Consumer Codes Approval Scheme: Core criteria and guidance,* section C11 (January 2016 revision). Available here.

[9] Consultation Paper, para 6.3.

[10] See Consultation Paper, Apx C.

[11] Chartered Trading Standards Institute, *Institute of Professional Willwriters Audit 2014*, p 5. Available here.

[12] From February 2012, the Deposit and Workmanship Warranty Insurance (DAWWI) scheme is one option available to members of the scheme who take deposits. See Consultation Paper, Apx C.

3.17 Some consumer codes provide for "mutual assistance". If a code member goes out of business or otherwise does not complete the service, the trade association will enlist another member business to complete the contract. The British Association of Removers (BAR) is an example. If a business cancels less than 10 days before the agreed removal date and BAR cannot find another member to complete the service, it will refund 150% of monies paid.

3.18 In the Consultation Paper we noted that the Furniture Ombudsman was attempting to obtain approval for a CCAS code.[13] By April 2016 its code had reached stage 2 approval.[14] This means that the code is being run in "ghost" with two major home improvement retailers to ensure that it works adequately ahead of a public launch.

OTHER VOLUNTARY CODES

3.19 Many other voluntary codes have been agreed by trade bodies without official backing. In the Consultation Paper we noted the proliferation of schemes, including TrustMark, "Buy with Confidence" schemes and British Kitemark schemes, offering varied levels of prepayment protection. It is sometimes difficult for consumers to evaluate the many logos displayed on traders' doors or websites, to know which schemes offer what protections. Most of the non-CCAS voluntary codes do not offer prepayment protection. In the Consultation Paper[15] we outlined schemes which do provide this protection, and below we discuss some of the most significant.

Christmas "savings" schemes

3.20 One important example is the code developed by the Christmas Prepayment Association, which was set up after the collapse of Farepak by providers of similar Christmas "savings" schemes. The members of the Association agree to adhere to a voluntary code of practice, which includes the obligation to hold consumer savings in trust (subject to certain drawdown permissions).[16]

New homes

3.21 Another example is the Consumer Code for Home Builders. All home builders who are registered with the main home warranty providers must abide by its 19 core criteria. One criterion is that builders must explain clearly "how home buyers' contract deposits are protected and how any other prepayments are dealt with". This is supplemented by guidance to builders:

> You should have arrangements to protect contract deposits paid by Home Buyers. The Home Warranty Body's insurance cover may include this protection.[17]

[13] Consultation Paper, para 6.39.

[14] http://www.tradingstandards.uk/advice/Prospectivecodesponsors.cfm.

[15] Consultation Paper, Ch 6.

[16] We discuss the Christmas Prepayment Association, and Christmas "savings" schemes generally, in Ch 5 below.

[17] Consumer Code for Home Builders (January 2010 edition) para 3.4.

3.22 The two largest home warranty bodies, NHBC and MDIS, offer a relatively good level of deposit protection. They will repay the amount the home buyer has already paid to the builder under contract and which they cannot recover, up to a limit of 10% of the original purchase price or £100,000, whichever is less.[18] However, we were told that some other warranty bodies offer less protection. They may, for example, include an excess, so that the buyer bears some of the loss. Alternatively, they may impose an aggregate limit on refunds for the development as a whole (for example, refunding not more than £1 million for a development), which may be exhausted before a claim is made.

3.23 Home builders who do not comply with the Consumer Code cannot register with the main home warranty providers. However, deposit protection is not compulsory. Home builders who do not comply with the code may still be able to offer warranties from other, smaller, providers to cover building work but not deposits.

Double glazing

3.24 The double glazing industry operates against a regulatory background. Under the Building Regulations 2010, those who install windows and doors must either obtain approval from their local authority or use a provider who is a member of a competent person scheme. In practice, it is simpler to use a scheme member.

3.25 There are nine competent person schemes for the installation of double glazing, of which the largest are FENSA and CERTASS.[19] Under the conditions for authorisation set by the Department for Communities and Local Government,[20] members must provide customers with financial protection to put work right for a minimum of six years. This effectively insures the work itself and is implemented by FENSA and CERTASS members through insurance-backed guarantees.

3.26 There is no statutory requirement to protect the deposit if the trader becomes insolvent before carrying out the work. However, FENSA and CERTASS impose additional requirements on their members. Both require that deposits are protected and both offer insurance, though FENSA permits other methods of protection.[21]

MANDATORY PROTECTION

3.27 In a few sectors, consumer prepayment protection is mandatory. Businesses are required to hold prepayments on trust, or to use insurance or bonding as an alternative.

[18] Alternatively if the property has been started, they may instead pay the additional cost up to this limit to complete the home in accordance with their requirements.

[19] CERTASS estimated that between 60% and 70% of the double glazing industry are members of a competent person scheme.

[20] Department for Communities and Local Government, *Building regulations; competent person self-certification schemes. Conditions of authorisation*, item 17. Available here.

[21] http://www.ggf.org.uk/homeowners-consumer-protection.

3.28 Most examples of mandatory regulation apply where businesses hold money belonging to consumers, rather than where consumers have made prepayments to the business. Examples are solicitors who hold client money, estate agents who hold deposits, and financial advisers given client money to invest. In these cases the money does not belong to the firm and it would be wrong for the firm to use it as working capital. There are therefore many provisions which require such firms to hold client money on trust in segregated accounts.[22]

3.29 It is less common for retailers to be required to protect consumer deposits. Where they are required to do this, the costs and difficulties associated with protection of prepayments still apply – although in these cases it is more likely that appropriate insurance products have been developed and made affordable because of the volume of demand. Mandatory schemes apply in the travel industry and to prepaid funerals.

Travel

3.30 Travel is a particularly high-risk sector. Typically consumers pay large sums, often long in advance of the service being provided, which makes them particularly vulnerable to retailer insolvency. There is also a risk that holidaymakers will be stranded abroad if their travel organiser collapses.

3.31 These concerns led to one of the first statutory schemes requiring protection of consumer prepayments. Since 1972, organisers who sell holidays involving air travel must hold a licence from the Civil Aviation Authority. The Air Travel Organisers' Licence (or ATOL) remains a major protection for those buying holidays which include flights.

3.32 This left questions about other forms of holiday, for example packages by coach, rail or sea. From the 1960s, trade bodies protected these on a voluntary basis. However, in 1990, the European Package Travel Directive required Member States to establish mandatory schemes covering all sales of package holidays.

3.33 Although the 1990 Directive does not distinguish between air and non-air holidays, the Government decided to build on the schemes already in place. The result is a complex combination of schemes which distinguishes not only between package and non-package holidays, but also between those involving air travel and those that do not. Packages not involving air travel are now subject to the Package Travel Regulations 1992,[23] which require travel organisers to protect consumer prepayments. Organisers are given a choice of three methods: bonding with an approved trade body, insurance, or trust arrangements.

3.34 More detail of these arrangements is given in the Consultation Paper.[24]

[22] See for example s 13 of the Estate Agents Act 1979 and the Financial Conduct Authority (FCA) rules, set out in the Client Asset Sourcebook (CASS).

[23] Their full title is the Package Travel, Package Holidays and Package Tours Regulations 1992.

[24] Consultation Paper, Ch 6 and Apx D.

Prepaid funeral plans

3.35 Consumers may wish to pay for their funeral in advance to avoid burdening relatives with these costs when they die. To address concerns relating to the insolvency of funeral providers, and the potential for consumers to be left without a funeral plan, HM Treasury introduced regulation, which took effect in 2002.

3.36 In essence, the provision of funeral plans is a regulated activity subject to FCA supervision under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the 2001 Order).[25] However, a funeral plan contract is exempt from FCA supervision if it insures the customer's life for the cost of the funeral or if it holds the money on trust for the purpose of providing the funeral.[26] In effect, therefore, the prepayments must be completely protected by trust or insurance. Otherwise, the funeral provider must be regulated by the FCA.

3.37 The 2001 Order makes provision about the nature of the trust, including that more than half of the trustees must be independent of the funeral provider and that the trust must be established in writing and annual accounts prepared.

3.38 The Funeral Planning Authority is a self-regulatory organisation for the funeral planning sector. It monitors compliance with the exclusion criteria in the 2001 Order and also enforces its own Rules and Code of Practice. For example, the Funeral Planning Authority requires insurance-backed protection coupled with an undertaking that another member will deliver the funeral in the case of member insolvency.

THE PROBLEMS OF PROTECTION

3.39 Protecting prepayments can be onerous for many traders. Putting money into trust is legally and administratively burdensome, and deprives the trader of working capital. Prepayment insurance is available in some sectors but in others it may be difficult to obtain, expensive and hedged with exclusions and conditions. Meanwhile, bonding is unlikely to provide sufficient cover on its own: ABTA's experience is that bonding needs to operate in conjunction with an insurance scheme.

[25] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, art 59 defines the provision of a funeral plan contract, where the customer makes one or more payments to the provider in exchange for a funeral in the United Kingdom on the customer's death, as an activity subject to FCA regulation.

[26] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, art 60.

3.40 In 2011 the OFT remarked that, of all the code criteria, some sponsors find prepayment protection the most difficult requirement to meet.[27] It can sometimes be a deal-breaker for trade bodies. For example, when the Direct Selling Association withdrew from the CCAS programme, it said that protecting the entirety of all consumer prepayments, though an entirely desirable policy objective, was a "costly and commercially unrealistic one in a commercially competitive environment".[28]

3.41 In the Consultation Paper we concluded that consumer codes have ameliorated the problems associated with consumer prepayments in many sectors. However, the reliance on voluntary action means codes attract the good firms; businesses with a poor track record of consumer protection do not sign up. The more onerous the requirements, the fewer firms are likely to join, and the more likely they are to leave when they encounter financial difficulties.

3.42 As a result, the protection provided by voluntary schemes may fail where it is most needed. For example, Farepak left the Direct Selling Association in 2004, before the Association's new code requiring prepayment protection was approved. As Farepak did not protect its prepayments, it simply left the scheme.[29]

3.43 The hope is that codes of practice will be a marketing tool: consumers will choose traders who comply with demanding codes. The problem is that consumers are now faced with a proliferation of schemes and logos and may have little idea of what protection is offered by which scheme.

CONCLUSION

3.44 The Government's policy of encouraging voluntary protection of consumer prepayments has worked well in some sectors. It works best in industries which operate against a regulatory backdrop, such as the competent person scheme for double glazing. However, deposit protection is an onerous requirement for businesses. Where businesses gain little advantage from membership of a trade body, voluntary codes are likely only to attract the best businesses in the sector. Customers of retailers which have not signed up are left exposed to losses on insolvency.

3.45 Extending voluntary protection for consumer prepayments is likely to encounter resistance from businesses. It may also fail to protect consumers when they need it most. As we discuss in Chapter 6, where a sector has been identified as posing a particular risk to prepaying consumers, regulation may be required to ensure consistent standards of prepayment protection.

[27] Response of the Office of Fair Trading to Department for Business, Innovation and Skills, *Consumer Landscape Review* (May 2011), para 9.16.

[28] Response of the Direct Selling Association to question 8 of Department for Business, Innovation & Skills, *Consumer Landscape Review* (May 2011).

[29] Memorandum submitted by Citizens Advice to Select Committee on Trade and Industry (October 2007), para 5.8. Available here.

CHAPTER 4
IS THERE A NEED FOR REFORM?

4.1 In this chapter, we consider the scale and nature of the problem and summarise the feedback we received from consultees on the need for reform. We then outline the case for and against reforming the protections for prepaying consumers.

AN INFREQUENT BUT EMOTIVE ISSUE

4.2 Retailer insolvency is still relatively rare. And, as discussed in Chapter 2, even where it occurs there are several ways in which consumers may be recompensed. In practice, the protections provided by credit and debit cards are particularly important; cards are now the most common method of payment.[1] Following a major collapse, card issuers often make refunds to consumers totalling several million pounds.

4.3 However, other than in few regulated sectors, the various protections are generally voluntary in nature.[2] They depend on commercial decisions taken by banks, administrators, and businesses. If the protections fail, there is no safety net provided by the Government or the law, and returns through the statutory hierarchy of payments on insolvency are usually derisory. This allows a situation where consumers can face sudden losses.

4.4 In many cases, any such loss is relatively low: we have seen that Zavvi, voucher holders experienced an average loss of only £8.12.[3] Furniture deposits, and the losses associated with them, tended to be higher: the analysis of case histories by Citizens Advice reported an average loss of around £700. However, this varied from trader to trader. In one extreme case, the average loss was over £12,000. The Farepak insolvency, where the average amount at risk was £400 per consumer, caused particular outrage because low-income families were especially vulnerable to the loss of their Christmas savings.

4.5 Large and significant losses are relatively rare, but they can occur. Even where losses of lower values are suffered, there is often outrage. The case histories given to us by Citizens Advice showed that consumers were often astonished to find that money paid in good faith had simply been lost, and that the law allowed this to happen. It was clear that consumers who complain to Citizens Advice struggle to understand insolvency law:

> I paid for a sink and bath suite from [trader] for £314.05 which was to be delivered tomorrow and have found out they have gone into administration and will not release any orders however they are still trading and I can re-buy the goods I've already bought. Is this correct and can they re-sell goods I have already paid for?

[1] Discussed in more detail in Ch 7.

[2] For example, administrators honouring prepayments, refunds through chargeback, or the business having put consumer prepayments into trust.

[3] Above, at para 2.44.

> I have bought furniture from [trader], and there are 3 pieces (dining chairs, a bookcase and an office chair) I have not received, totalling just short of £1,000…. In the meantime [trader] was bought back by one of its founders, but… now claims that it is a totally different company and will not honour any outstanding orders…. I don't understand how this is legal?

4.6 The anger may become more intense where consumers see goods which they have paid for (and which they believe to belong to them) being offered for sale to other consumers. In response to our consultation, Citizens Advice made this point saying:

> Our clients' sense of confusion and injustice was heightened in cases where the insolvent retailer was taken over by another business or the decision was taken to trade in administration. Clients could not understand why goods which they had already paid for, and had been told would not be delivered, were available for other consumers to pay for and take away.

4.7 When consumers find their prepayments have become worthless they tend to use terms like "fraud", "robbery" and "theft", as these three quotations illustrate:

> At Christmas I purchased £40 worth of vouchers as presents then a few weeks later they went into receivership. The administrators say that the vouchers will not be honoured, but the stores are still open and trading. I feel as though I have been robbed.

> I consider the actions of [trader] to be blatant robbery… Why can they legally still sell goods for cash when they won't accept me to use money they already have of mine?

> They are still accepting customers' money and these gift cards have been purchased for which no goods have been exchanged – is this not theft?

4.8 In all these cases, the insolvency practitioner's stance was lawful. While solvent companies often respond to consumer concerns by doing more than the law demands, administrators are strictly constrained: they are not allowed to prefer consumer claims over the claims of other creditors.

4.9 This discrepancy between consumer expectations and the law can lead to negative press coverage[4] and swollen postbags to Members of Parliament.[5] In discussions, several administrators recalled the public disorder associated with the World of Leather insolvency in 2000. The discrepancy also raises questions about whether the law should be changed.

A NEED FOR REFORM?

4.10 When companies become insolvent, it is inevitable that losses will fall on creditors. The very definition of insolvency means that some – usually most – creditors will lose out. We do not think that consumers can or should be sheltered from all loss.

4.11 As the Cork Committee pointed out in 1982,[6] consumers often lose small amounts whereas other unsecured creditors, such as individual contractors, may suffer much greater hardship. For example, when CityLink entered administration in December 2014, many of its van drivers were classified as contractors rather than employees. They were therefore treated as unsecured creditors, alongside consumers. They lost both their source of income and outstanding payments due to them.

4.12 On the other hand, in the Consultation Paper[7] we identified four reasons why the protections offered to consumers should be re-examined with a view to enhancing them:

(1) The discrepancy between consumer expectations and the law raises questions about whether the balance is right.

(2) The retail economy depends on consumer confidence. That confidence could be dented by even a handful of retailer insolvencies if significant consumer losses are sustained.

(3) Consumer prepayments bring new money into the business. Consumers are in effect lending money to the business but, unlike other lenders, they do so without the opportunity to investigate the insolvency risk, without taking security and without charging interest.

[4] For example, “Republic owner refuses to honour vouchers for bust fashion chain”, *Guardian* (23 April 2013). Available here.

[5] For example, after the World of Leather insolvency, Bill Tynan, the MP for Hamilton South, said in Parliament: "My constituents find it totally unacceptable and immoral that, on the same site where Land of Leather and Uno previously traded, a new company trading under the name of New World of Leather is selling stock previously owned by World of Leather and Uno as bankrupt stock”, Hansard (HC), 24 May 2000, pt 3, col 253WH.

[6] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558.

[7] Consultation Paper, para 8.10.

(4) Businesses with financial problems (who find it difficult to borrow money from sophisticated lenders) may seek to increase prepayments from consumers in order to improve cash flow, despite knowing that the goods or services may never be delivered. Under the current rules, it is floating charge holders who benefit directly from these prepayments. This may provide a perverse incentive for businesses and their floating charge holders to seek to increase prepayments in the weeks and months prior to insolvency.

4.13 We asked consultees whether, in these circumstances, the protections available for some types of consumer prepayment on retailer insolvency should be reformed.

Consultees' views

4.14 We received 31 responses to this question. Of these respondents, two thirds agreed that this was an area in need of reform.[8]

Arguments in favour of reform

4.15 Consultees noted the significant discrepancy between the perceptions of consumers as to what is fair, which influences their expectations in an insolvency, and their actual legal status and rights. Jessica Morden MP commented:

> Too many consumers who can ill-afford the loss of a service or goods have experienced such a loss. They often feel they have little recourse to remedy the situation, while other established institutions ensure they are always in a position to recoup the majority, if not all, the monies they are owed.

4.16 Several consultees argued that the detriment was potentially severe. Furthermore, they pointed out that prepaying consumers provide businesses with a valuable source of "new money". For example, Professor Sheehan thought that it might be appropriate to treat consumer prepayments more favourably on insolvency because they brought new money into the business.

4.17 The Farepak Victims Committee said:

> Consumers are still unaware that because you have 'pre-paid' for an item you are effectively 'loaning' that particular company your money because as the law stands they can use those very same funds to bolster the whole company.

4.18 The Competition and Markets Authority (CMA) argued that consumers require protection because they are unable to assess insolvency risks:

[8] 20 (65%) agreed that this was an area in need of reform. Three disagreed (10%) and eight made other comments.

We believe that consumers paying in advance are not well placed to assess insolvency risks in relation to particular businesses or sectors. We would therefore favour measures that provide such consumers with improved protection given their limited ability than other creditors to assess and manage the potential likelihood of, and risks arising out of, insolvency.

Arguments against reform

4.19 Only three respondents thought that reform was not required. The Association of British Insurers (ABI) doubted the seriousness of the issue. They said they were:

> not aware of evidence that points to a widespread or systemic issue in terms of consumer detriment or a high frequency of insolvencies impacting adversely on customers.

4.20 The Insolvency Lawyers' Association (ILA) thought that any legislative changes would be "unduly complex". They echoed the Cork Report, saying:

> We see no reason in principle why this class of creditor should obtain benefits not available to others (for example employees) who may arguably be equally "vulnerable", and whose losses in the event of an insolvency may exceed those suffered by consumers… with consequent greater hardship.

4.21 Many of those who accepted some need for change also expressed concern that protection should not come at a disproportionate cost. Into the Blue, a provider of "experience" day vouchers, noted:

> The cost of any scheme needs to be balanced against the likely hardship caused to consumers. … [G]ift vouchers … tend to have a fairly low average value and the fact that they are bought as a gift would suggest that actual hardship caused by an administration would usually not be of a very high order.

4.22 Similarly, the CMA stressed the need to:

> weigh the cost to consumers of any proposed protection measures (whether direct, or likely to be passed on through increased prices) against the potential benefits.

4.23 Professor Sheehan argued that the need to maintain consumer confidence was not a strong reason for intervention. Although "the retail economy more widely might be damaged by a large insolvency", he thought that consumers might:

> pretty rapidly forget the impact of an insolvency – unless personally affected by it – and that the voucher market after a dip would recover quickly.

GENERAL THEMES

4.24 Most stakeholders recognised that the issue was a difficult one, with many competing considerations to be balanced. Several themes emerged from the responses.

Prepayments are a fact of life

4.25 Stakeholders generally accepted that prepayments were a feature of the modern retail landscape. There were few calls to restrict businesses' ability to take prepayments, although the Farepak Victims Committee said that, in an ideal world, all consumer prepayments would be regulated:

> Some businesses will quote the 'my business will not survive without the prepayments given to it'. We have a simple answer for that, your business is clearly not functioning as it should so therefore the last thing you should be doing is taking prepayments.

4.26 The more common view was that some businesses rely legitimately on consumer prepayments as working capital. Park Group said:

> Prepayments can be used to provide the ability to purchase raw materials. Any regulation introduced to protect consumers will increase the working capital requirement which could be difficult to obtain from the banking sector. This would increase the risk of failure and make it difficult to enter the market, reducing choice and ultimately the provision of the service and jobs.

4.27 Stakeholders in the gift voucher industry were keen to stress that nothing should be done to damage the value of gift vouchers generally:

> This product has a firm place in our marketplace and it is important to recognise the reasons why consumers purchase cards and vouchers for themselves or others. [UK Gift Card and Voucher Association]

Concerns about post-insolvency protection

4.28 Generally, insolvency practitioners argued against any change to the post-insolvency regime. For example, the Institute of Chartered Accountants of England and Wales (ICAEW) warned against reactive changes:

> Losses arising from insolvency may give rise to political pressure for change to address the concerns of whatever group of creditors has been adversely affected at a given time, but insolvency always produces losers and the UK's insolvency regime needs to be set on the basis of long term, objective considerations.

4.29 Several insolvency practitioners suggested that the answer lay in improving director behaviour and consumer education. For example, PwC said:

> Whilst we can understand that policy decisions may be considered to protect vulnerable people, dealing with the issue from an insolvency perspective is too late, and may create unintended consequences…
>
> Improving director behaviour, better communication of existing protections and wider consumer education at point of sale should alleviate many of the concerns that have given rise to this consultation.

4.30 The Scottish Technical Committee of R3 (a professional association for insolvency specialists) made a similar point:

> The insolvency regime is not the appropriate method or forum for reform of consumer prepayments. We see this as a behavioural and social issue rather than an economic issue.…
>
> The issue is therefore, in our view, one of:
>
> - director behaviour and responsibility;
> - consumer education – understanding the risks but also the protections available;
> - communication from the retailer to their consumers, backed and supported by the banking and credit cards system.

Extending the law on directors' liability? Our comments

4.31 We summarise the law on directors' liability in Appendix B. We look at three possible legal sanctions: wrongful trading, fraudulent trading and director disqualification.

4.32 Although the law of wrongful trading could, in theory, provide compensation to consumers, there are three problems with it:

(1) Claims can only be brought by administrators and liquidators. They are extremely rare: we identified only 11 successful cases in 27 years, and none of them concerned consumer prepayments.

(2) The bar is high. Directors must trade with no reasonable prospect of avoiding insolvency. In practice, the courts will not penalise directors acting in good faith to save their company.

(3) Even if the claim succeeds, consumers and other unsecured creditors are unlikely to receive any compensation.

4.33 Director disqualification proceedings are more common: 1,208 disqualifications were made in the financial year 2015/16, though we identified only two successful cases which were primarily concerned with lost deposits.[9] Disqualification proceedings are brought by the Government, and the test is more general.

4.34 Traditionally, disqualification proceedings have not provided compensation to consumers, but the law changed in May 2015. The Secretary of State may now seek a compensation order against a disqualified director for the benefit of a class of creditors, such as consumers.[10] At the time of writing it is not clear what effect this change will have.

[9] See Apx B from para B.63.

[10] Company Directors Disqualification Act 1986, s 15B. Discussed in more detail in Apx B, from para B.38.

4.35 As the law has changed so recently, and issues of directors' liability extend beyond the limited issue of consumer prepayment, we do not make any recommendations in this Report for further change. However, we think the provisions on director disqualification and directors' duties more generally should be monitored for effectiveness. There may be a case for revisiting them in future to bolster the principles of responsible director behaviour.

Consumer education? Our comments

4.36 We can see strong arguments for better information about chargeback. Below, we also recommend that the Government should remind consumers that gift vouchers are vulnerable to retailer insolvency, and not equivalent to cash.

4.37 However, it may be unrealistic to expect consumers to weigh insolvency risks in their daily transactions. As we have argued in the context of unfair terms, consumers have only so much time to devote to each transaction.[11] Some risks (though serious) are so low that they fall below a consumer's threshold of concern.

4.38 Consumer education about insolvency law may reduce some of the shock and surprise caused by insolvency losses. However, it may also cause greater public challenge to a process which is seen to protect banks and other financiers at the cost of other creditors who were not in a position to take securities over their "loans".

Pre-insolvency protection? Our comments

4.39 Several insolvency practitioners argued that the better solution was for solvent businesses to put arrangements in place for protecting prepayments as a matter of course. By contrast, businesses selling to consumers pointed to the costs and difficulties of any pre-insolvency protection, such as trust arrangements or insurance.

4.40 Chapter 3 provides examples of many voluntary schemes to protect consumer prepayments, including schemes for double glazing and home builders. These schemes are an important part of the consumer protection landscape. However, they have limits. Businesses are reluctant to comply with onerous standards if less scrupulous competitors can operate without incurring the costs of compliance.

4.41 As we discuss in Chapter 6, where a particular sector poses a risk of significant consumer detriment, there may be a case for mandatory protection.

[11] See Law Commission, *Unfair Terms in Consumer Contracts: A New Approach, Issues Paper*, July 2012, Ch 3.

REGULATING GIFT VOUCHERS[12]

4.42 When a high street retailer becomes insolvent, one of the most high profile issues in terms of media coverage and consumer interest is the question of what happens to the gift vouchers in circulation. The announcement that BHS had entered into administration gave rise to many articles focussed on consumer rights.[13] If the administrators announce that vouchers will no longer be accepted, or that holders must spend a certain amount of money before vouchers can be used, this is often met with outrage and calls for a change in the law in order to introduce consumer protection.[14]

4.43 We therefore look at this sector first.

The current law

4.44 The United Kingdom has one of the most developed and varied gift card and voucher markets in Europe, worth £5.4 billion per year.[15] In the Consultation Paper we described the many ways vouchers may be provided and redeemed.[16]

4.45 Only a tiny proportion of gift vouchers are currently regulated. As we explain in more detail in the Consultation Paper, regulation applies only to "open loop" electronic cards: that is, cards which may be used in a wide range of retailers for a variety of purposes. Examples include the Love2Shop gift card and the One4All gift card. These products are subject to the Electronic Money Regulations 2011, which implement a European Directive.[17] The issuer must safeguard all funds received in exchange for the electronic money issued, either by segregating the funds in a separate bank account or low-risk investment, or through insurance.[18]

[12] Rather than repeat the cumbersome phrase "cards and vouchers", we use the term "voucher" to refer generically to all gift tokens including paper-based vouchers, plastic cards and digital vouchers.

[13] For example, 'BHS collapse: What to do if you have store vouchers or items to return', *Independent* (25 April 2016), available here; 'Spend your BHS vouchers 'as quickly as possible' shoppers told as store goes into administration', *Mirror* (25 April 2016), available here.

[14] For example, the HMV administration led to an MP proposing a private members' bill which would make purchasers of gift vouchers preferential creditors during the administration of a company. The Bill failed to complete its passage through Parliament before the end of the 2012-13 parliamentary session and therefore fell.

[15] See UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014*, available here.

[16] Consultation Paper, Ch 7.

[17] The Second Electronic Money Directive: Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC.

[18] EMR 2011, regs 20, 21 (segregation) and 22 (insurance).

4.46 Other cards and vouchers are not regulated: this includes paper vouchers, and electronic cards which may be redeemed only at the issuer's stores or which fall within the "limited network exemption". This exemption applies to cards which can be used only in a limited network of service providers or only for a limited range of goods or services.[19]

Should all gift vouchers be regulated?

4.47 In the Consultation Paper, we asked consultees whether encouraging retailers to protect gift vouchers on a voluntary basis was preferable to introducing a mandatory requirement. The majority of consultees agreed that it was.[20] We set out the main arguments below.

Arguments for mandatory protection

4.48 The arguments in favour of protecting consumers with gift vouchers were largely the same as those for protecting consumers generally: consumers are often unaware of the risks of losing the voucher, and are not in a position to take into account a retailer's solvency risk when making the purchase. Specifically for gift vouchers, a further argument is that the retailer has received an upfront payment for goods or services it has yet to provide, so it should hold that money separately until the voucher has been used. In the case of low income consumers, even the loss of a small denomination voucher could cause some hardship, and considerable disappointment.

4.49 Some stakeholders, including consumer groups, argue that all vouchers should be regulated, and the funds protected. They have voiced concern that voluntary measures would prove ineffective.

4.50 In her response to our consultation exercise, Jessica Morden MP said:

> While making moves to encourage voluntary compliance would be welcomed, introducing mandatory prepayment is preferable. Protecting consumers should not be left to the conscience of a profit-making company. Their priority, not unreasonably, is to return a profit, not ensure consumers are protected if they fail.

4.51 It is true that businesses which adopt voluntary protection measures are at a competitive disadvantage: they either have to incur the cost themselves or pass it on to the consumer, whilst those choosing not to adopt protections can continue to offer lower prices. From this perspective mandatory measures provide a level playing field. Although additional protection could attract new customers in the long term, it would be at the expense of short term profit so businesses would be unlikely to take the step voluntarily.

[19] EMR 2011, reg 3(a). The Financial Conduct Authority has given guidance on how this provision is to be interpreted: see Consultation Paper paras 7.39 to 7.48.

[20] Of 34 respondents who answered this question, 21 (62%) agreed; nine (26%) thought that mandatory protection was a better alternative and four (12%) answered "other".

Arguments against mandatory protection

4.52 As we discuss elsewhere in this Report, we think that, in some circumstances, there is a case for giving consumers additional protection. However, we do not consider the arguments to be as strong in the context of gift vouchers.

4.53 As we explain in Chapter 2, we have found that the individual losses associated with gift vouchers on retailer insolvency tend to be moderate rather than severe. Our analysis showed that for most vouchers, losses were relatively uncommon, and when they did occur consumers usually lost only small amounts.

4.54 In addition, vouchers are usually given as gifts. The creditor who would benefit from any protection for the funds would be the original purchaser, rather than the holder. The holder of the voucher has not spent their own money and the items likely to be purchased with them may be less likely to be of critical value to the holder. Often anger or disappointment was the real problem, rather than financial hardship. Of course, this is not always the case – one stakeholder mentioned the situation in which several friends and family members each give £10 or £20 vouchers to an expectant mother in order to buy a pram. In that case, the cumulative value of the vouchers held by the recipient may be significant, and they may suffer more than just disappointment if the vouchers are rendered useless.

4.55 Nevertheless, the majority of respondents to the consultation argued against regulation. Many thought that this would be a disproportionate solution to a relatively small issue in the overall scheme of a retailer insolvency.

4.56 The City of London Law Society said:

> Introducing a mandatory regulatory regime to protect the holders of gift cards would seem disproportionate, as while this is often an emotive issue at the time of a retail insolvency and one which may generate media interest, the size of the problem seems to be comparatively insignificant.

4.57 Regulating all gift vouchers would impose a significant burden on a wide range of businesses. Small businesses, from florists to butchers, can and do issue vouchers and would find the cost, of administering trust accounts for example, particularly burdensome.

4.58 Respondents from the gift voucher industry stressed the costs of regulation. The UK Gift Card and Voucher Association (UKGCVA) summarised the argument as follows:

> To deliver a card programme with no or minimal charges to the consumer, there is little room for accommodating measures that have a cost associated with them. Ultimately any additional cost would be passed on to the consumer, for example as a fee. The regulated gift card market is an example of this, whereby a purchase fee and/or a monthly administrative charge is applied and a significant proportion of such fee is used to cover the cost of running the programme and meeting regulatory obligations.

4.59 Most insolvency practitioners thought that the emphasis should be on informing consumers about the risks prior to purchase. Deloitte said:

> Vouchers should be clearly differentiated as between those underpinned by a trust (the savings scheme products) and those that are not. In the latter case, any notification that the value of the voucher will likely be lost on insolvency should be sufficiently prominent to alert the consumer to the possibility that the intended gift may be worthless.

Conclusion

4.60 Whilst we would continue to encourage gift voucher retailers to offer voluntary protections to consumers, in whatever form they may decide, we do not think that blanket regulations and requirements across the sector are feasible or desirable. Although it is true that severe losses are sometimes suffered by individual voucher holders, these individual cases of hardship would not justify regulation of all vouchers. We think that the economic burden on businesses would be disproportionate to the benefits which consumers might receive in return, particularly when the costs of any protection are likely to be passed on to all consumers. The case for preferring voucher holders over other unsecured creditors is not made out.

Consumer education

4.61 However, it does appear that many consumers are not aware of the risks associated with retailer insolvency, particularly where vouchers are received and then not spent for several months or even longer. Consumers should be in a position to make informed decisions. We think that an awareness among consumers that vouchers are not, despite appearances, the equivalent of money, may encourage consumer to spend vouchers sooner and help them understand that, in the (relatively unlikely) event of the retailer's insolvency, they may lose out.

4.62 To that end, we asked consultees if gift voucher providers should state in their terms and conditions whether they are protected in the event of insolvency.

4.63 Although most respondents supported the idea of improving consumer awareness, some strong arguments were put against adding more small print to consumer transactions.[21] Several respondents doubted that the terms and conditions of a gift voucher are ever read and, if so, if they have any impact on the consumer. The City of London Law Society said:

> As a practical matter, it feels improbable that (for example) a relative looking for a last minute £10 gift for a young nephew, with a queue forming behind them, would, prior to making that purchase, read the terms and conditions of the voucher (if available) and then make decisions as to whether or not to proceed with the purchase based on that review.

[21] Overall, 31 consultees responded to this question: 26 (84%) were in favour of the proposal and 5 (16%) against it.

4.64 As an alternative it was suggested that a statement should be included on the face of the voucher so it could be seen by the recipient. However, delivering an effective message on that space is likely to pose considerable difficulties. The resulting voucher may look less like an attractive gift and more like a health warning.

4.65 We think however that there remains a need to educate consumers – as both purchasers and recipients – that gift vouchers are vulnerable to retailer insolvency, and are not a direct substitute for cash. We have considered how that message can best be communicated.

4.66 We think that, from time to time, the Government should put out a press release highlighting that most vouchers are not protected on insolvency and should therefore be spent promptly. This would not only help to reduce consumer losses in an insolvency; it would also encourage recipients to spend their gift vouchers rather than losing or forgetting about them or allowing them to expire. The issue arises each year immediately after Christmas so a communication around the New Year might be particularly effective. We would hope that the mainstream media, and consumer bodies such as Citizens Advice and Which?, would also share this message with consumers.

WHICH SECTORS POSE SIGNIFICANT RISK?

4.67 In the Consultation Paper, we asked whether there were other sectors in which consumers were particularly vulnerable to more significant losses on retailer insolvency, and where regulation might be justified.

Consultees' responses

4.68 We received 29 responses identifying many different sectors. Several mentioned the two areas which are already subject to statutory protection: funerals and travel.

4.69 Among non-regulated sectors, four respondents identified Christmas "savings" schemes as problematic. The Chartered Trading Standards Institute (CTSI) described them as "the most obvious case where insolvency can cause considerable detriment to some of the more vulnerable people in society". We agree that this is a particularly perilous sector, and make recommendations in Chapter 5.

4.70 Four respondents mentioned weddings. Here PwC observed there is a "deep emotional response" when prepayments are not fulfilled.

4.71 Utility companies were mentioned, and we are aware that Ofgem is keeping the protections for consumers in this sector under review. It is common for consumers to have a credit balance with their gas or electricity supplier. This will occur at particular times of the year for fixed monthly direct debit payment plans. It may also occur because the customer makes an upfront payment or because billing issues lead to overpayment. As these payments are frequently paid by direct debit rather than by credit or debit card, they are unlikely to be protected by chargeback arrangements.[22]

4.72 The following sectors were also suggested:

(1) concerts and sports tickets;

(2) building trade;

(3) car hire and sales;

(4) online transactions;

(5) telecommunications;

(6) media;

(7) currency exchange; and

(8) storage services.

Warranties

4.73 In the Consultation Paper we explained that we had not considered extended warranties. Many are regulated as insurance, while others are more akin to extended liability for faulty goods rather than a prepayment. However, sometimes a retailer's extended warranty is a separate service for which the consumer has prepaid.

4.74 In 2014, the issue of Scottish Power's "cash-back" warranties re-emerged and led to the creation of an all-party Parliamentary group to investigate.[23] Scottish Power had sold these warranties to consumers who purchased white goods from their stores between 1998 and 2001. If consumers did not claim against the warranty within five years they were entitled to their money back. However, in 2003 Scottish Power sold its stores and the company which issued the warranties to Powerhouse. Scottish Power argued that an indemnity it had provided in relation to the warranties was flawed and did not require it to indemnify Powerhouse against cashback claims. Powerhouse subsequently became insolvent, leaving 625,000 consumers owed some £75 million.

[22] We discuss how our proposals might affect an energy company insolvency in Apx D.

[23] All-Party Parliamentary Group on Scottish Power Cashback Mis-selling. The APPG has published a report, *Corporate dishonesty and regulatory failure: How 625,000 UK consumers lost out on the PowerPlan Cashback Promise.* Available here.

4.75 This issue demonstrates the wide and unpredictable range of circumstances in which consumers can become creditors (as discussed below).

Problems in singling out specific sectors

4.76 Many respondents argued that it was not possible to single out high-risk industries. The Farepak Victims Committee and Jessica Morden MP suggested that protection should be extended to all prepayments. Similarly, Book Tokens Ltd and the CMA argued that the key factors should be the size of the prepayment and the length of time the prepayment would be held for, rather than the particular sector in which the prepayment was made.

4.77 There are also difficulties, given the scope and timescale of this project, in conducting targeted research at particular industries where many small providers, rather than large high street retailers, are involved. Such sectors include independent wedding venues and small-scale builders.

4.78 In Chapter 5 we argue that the Farepak experience exposes "savings" schemes as one sector in which intervention is justified. Beyond that, it has not been possible to identify the sector or sectors most likely to give rise to the next consumer prepayment losses. Instead, the trend of opening up markets to new entrants, combined with rapid changes to consumer practice and payment methods mean that losses to consumers on insolvency can (and probably will) occur in new and unexpected places.

4.79 However, it is clear that sector specific intervention – whether industry led or through regulation – has been highly effective in areas where consumers are particularly vulnerable such as travel and double glazing. In Chapter 6 we recommend that the Government takes a regulation-making power which would allow it to act quickly to require the protection of consumer prepayments in sectors which emerge as high risk for consumers.

4.80 In Chapter 8, we also discuss the possibility of a general change to insolvency law rather than relying solely on sector specific provisions. Our recommendations about increasing the transparency and usability of chargeback (Chapter 7) and on the timing of transfer of ownership (Chapter 9) would also apply in all sectors.

CONCLUSION

4.81 Inevitably, insolvency law is required to allocate or apportion loss between innocent parties. There are no right answers about where losses should lie. Instead, the rules reflect societal and political judgements.

4.82 Consumers are a valuable source of new money benefitting businesses and, on insolvency, their floating charge holders. However, unlike floating charge holders, consumers are particularly ill-equipped to understand or assess the risks associated with making a prepayment to a retailer. Consumers also struggle to comprehend how they can be totally unprotected on insolvency. There is a risk that one or two insolvencies leading to major consumer losses could unsettle consumer confidence in the retail market.

4.83 On the other hand, insolvency will always mean that some – often many – creditors lose out. Each consumer tends to lose only a small sum: other unsecured creditors such as small suppliers or self-employed contractors may lose much greater sums and suffer more hardship in comparison. Protecting consumer prepayments may deprive businesses of much needed working capital or may add overheads to the business which are then passed on to consumers through price rises. There is a balance to be struck between facilitating business and keeping costs down, on the one hand, and encouraging responsible business practices and consumer protection on the other.

4.84 This Report does not advocate a single solution. Instead it provides Government with a range of recommendations – of varying strengths – which could be drawn on in whole or part if the political decision was made to improve consumers' position.

CHAPTER 5
CHRISTMAS AND OTHER SAVINGS SCHEMES

5.1 The most infamous instance in recent years of insolvency affecting consumers arose when Christmas savings club Farepak collapsed in 2006, owing £37 million to around 100,000 consumers. The issue caused great public concern. The consumers, many of them on low incomes, had saved an average of £400 with Farepak, and some had saved £2,000.[1] They waited six years for payment. Although they eventually obtained around 50 pence in the pound, 70% of this came from compensation funds set up to meet hardship.[2]

5.2 Christmas and similar "savings" schemes can be high risk: funds are typically held for a relatively long time and tend to represent significant amounts to the consumers concerned. Consumers who are saving money expect protection, as they would have if they put their money in a bank. However, the protections available to bank customers are not available to customers of this type of scheme, which provide hampers or retail vouchers rather than cash at the end of the saving period. They are not therefore caught by banking regulations.

5.3 In this chapter, we start by describing the Christmas club market. We then recommend regulation to protect prepayments in schemes which are marketed or operate as a form of savings. This would mainly affect Christmas clubs though we also came across other examples where vouchers were marketed as savings schemes. For example, one travel company advertised its gift cards as "a great way to save" towards a special holiday, while a toy shop described its re-loadable gift card for children as a "piggy bank". We have no concerns about holiday or toy vouchers as such but we do not think they should be marketed as suitable for saving unless the funds are protected.

THE CHRISTMAS CLUB MARKET

5.4 Christmas clubs appeal mainly to consumers on lower incomes. They provide a way to "lock" money away, so that it cannot be withdrawn early and used for any other purpose. Money is often collected in cash by people known to the consumer, so it is a "local" way of saving.

5.5 A Parliamentary Select Committee described the perceived benefits as follows:

[1] S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009) p 6.

[2] 'Farepak victims to receive 50p for every £1 saved', *The Guardian* (10 July 2012). Available here.

> A key strength of that product lies in the use of agents who collect payments, providing a vital prompt to save for those who might not otherwise do so. ... Customers are usually recruited by agents from among relatives, friends, neighbours or work colleagues, ensuring a strong social bond underlying the transaction. … Agents also deliver hampers and other products to customers, and this aspect of home service is particularly appreciated by elderly customers and less mobile customers and those in rural areas.
>
> Customers of hamper companies greatly value the idea that the money paid to agents is "untouchable" and that Christmas has been paid for in advance. The Pomeroy review observed that the double "lock-in"—that money could not easily be returned and that its value was returned in the form of vouchers or products so that it was spent on Christmas—was seen as the key benefit by many customers: "the effect is to insulate the money saved against any financial pressures that the household may experience and to remove the temptation to spend it on anything other than goods for Christmas".[3]

5.6 It seems that consumers often consider these benefits to outweigh the fact that, unlike savings accounts, such schemes offer no interest.

Use of consumer funds by the business

5.7 The money collected by Farepak from consumers was mingled within the general funds of Farepak and its parent and group companies. Several years previously, the group had bought a toy and book retail chain which had proved to be a bad business decision resulting in major losses to the group. Farepak's funds therefore went towards reducing the parent company's overdraft with HBOS, with Farepak becoming an unsecured creditor of the parent. Before its collapse, Farepak's money was also used towards operating costs of other companies in the group.[4]

5.8 The use of Farepak's money by the group was legal, but it was not necessary to the running of the Christmas savings scheme. The Parliamentary Select Committee considered how such businesses made a profit, noting that the business model usually worked as follows:

> Hamper companies earn income from the profit margin on hampers and other products, the discounts they obtain from retailers on vouchers and the interest earned on the money pre-paid to them by customers.[5]

[3] Select Committee on Treasury, Thirteenth Report, Session 2006-07, paras 65 and 66. Available here.

[4] Unusually, the judge made a statement after the collapse of the Secretary of State's case against the Farepak directors which gives more detail about the group's finances. The statement, which we discuss below from para 8.64, is available online at https://www.judiciary.gov.uk/judgments/farepak-judges-statement/.

[5] Select Committee on Treasury, Thirteenth Report, Session 2006-07, para 71.

5.9 Unlike many businesses, Christmas clubs do not need to rely on consumer prepayments for working capital, and several have been able to operate successfully while putting most of their holdings in trust.

No requirement to protect prepayments under the current law

5.10 Christmas clubs do not return cash to consumers in the way that banks and building societies do. Instead they take prepayments for products, services or vouchers. Where savings are returned in cash, the business is regarded as "deposit-taking".[6] This is an activity regulated by the Prudential Regulation Authority (PRA).[7] The deposits would also be protected by the Financial Services Compensation Scheme (FSCS).[8]

5.11 However, Christmas clubs are not regulated as "deposit-takers", nor are they subject to any other direct regulation. There is no legal obligation on these businesses to take steps to protect consumer prepayments.

Voluntary protection

5.12 After Farepak collapsed in 2006, the Department for Business, Enterprise and Regulatory Reform liaised with the industry to develop a voluntary code of practice.

5.13 The result was the Christmas Prepayment Association (CPA), a self-regulatory trade association for the Christmas savings industry. It currently has six members, who all agree to adhere to a voluntary code of practice.[9] Members must hold consumers' savings in a trust overseen by trustees, half of whom must be independent of the member. The trusts may be subject to draw down provisions which allow operators to use some money for trust overheads and other working capital. For example, the Park Christmas Savings Club has arrangements in its trust deeds to allow the business to "draw down" working capital subject to certain protections and limits.[10]

5.14 There are still retailers – from supermarkets to small businesses – which have not signed up to the CPA but which continue to offer Christmas savings schemes. Some supermarkets do put money in trust. For example, the Co-operative Food's "saving stamp" scheme is backed by a trust in which consumers' money is protected, again subject to certain draw-down arrangements.[11]

[6] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, art 5.

[7] Financial Services and Markets Act 2000 (PRA-Regulated Activities) Order 2013, art 2. The PRA is part of the Bank of England and is responsible for the prudential regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms.

[8] http://www.fscs.org.uk/what-we-cover/about-us/.

[9] A list of members of the Christmas Prepayment Association is available here.

[10] See clause 8 of Park's declaration of trust, available here.

[11] Subject to the costs of administering the trust being drawn from it in certain circumstances. We are grateful to the Co-operative Group for providing us with a copy of the trust deed.

5.15 However, another large supermarket we spoke to kept consumers' Christmas savings in a separate account but had not declared a trust over them. This means that in the event of insolvency the money would be part of the company's general assets: it would have to be shared between creditors as a whole and could not be repaid to savers, who would rank merely as unsecured creditors.

Comment

5.16 Given the size of the Farepak collapse, and the public anger it caused, it is worrying that some businesses are continuing to operate Christmas savings schemes without protecting consumer prepayments.

5.17 The OFT suggested that Christmas savings schemes could not be required to hold funds on trust because they needed to use funds as working capital.[12] We disagree with the OFT on this point. A savings scheme on its own does not require significant working capital and we think that these schemes should not be using consumers' payments to finance other operations. Members of the CPA have already agreed to hold sufficient money in trust to meet their obligations.

5.18 Supermarkets do need working capital to service other parts of their business, but they are sufficiently large and well financed that this should not need to come from consumers' savings. Supermarkets benefit from Christmas savings schemes because it increases their sales; we doubt that they are needed to raise working capital. In some cases, the failure to declare a trust over savers' money appears to be simply that the company has been reluctant to contemplate its own insolvency.

5.19 We think that the Farepak case, and the perception among consumers that they are "saving" with a financial institution despite the fact that some schemes still do not protect consumer prepayments, demonstrates a need for Government intervention in the sector. This is particularly so because it is often the most vulnerable who choose these alternative forms of "saving" in an effort to be financially responsible.

CONSULTATION PROPOSALS

5.20 In the Consultation Paper we suggested that the main mischief was offering a scheme as a form of savings mechanism without the protections normally associated with saving and expected by consumers. We proposed that it should be an offence to market a product as being suitable for saving unless the prepayments were protected.

5.21 We envisaged that most businesses would hold consumers' money on trust, though insurance or bonding would also be an option.

[12] Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006).

CONSULTEES' VIEWS

Strong support

5.22 Our proposal was strongly supported. Of 28 consultees who responded, nearly all agreed.[13]

5.23 KPMG said:

> We do feel that some level of regulation should be operated for products marketed as consumer savings schemes as this is a different scenario entirely to a gift voucher or paying a deposit for the delivery of an item or service.

5.24 The Institute of Chartered Accountants of Scotland agreed:

> Saving schemes are often used by the most vulnerable in society and therefore additional measures of mandatory protection should be afforded to such schemes.

5.25 The gift voucher industry agreed that vouchers should not be sold as suitable for savings. The UK Cards and Gift Vouchers Association, and several of their members, said:

> We do not endorse gift cards and vouchers as a suitable product to be used for saving. Gift cards and vouchers are promoted as products to be used for gifting and spending.

5.26 Consumer groups argued that consumers should not be misled. The Farepak Victims Committee thought that "the word 'savings' gives the impression that your money is safely deposited in a 'savings account'". Jessica Morden MP said

> Most people would assume [from] anything marketed as a saving scheme that their money is safe and in an account. In practice, this is not how the system operates and leads to huge confusion when things go wrong.

Some thought we should go further

5.27 Several of those who agreed with the proposal thought that savings schemes should be subject to an even greater form of regulation than we proposed. They argued that schemes marketed as savings schemes should be subject to the same regulation as other financial services.

5.28 This view was taken by six insolvency practitioners. The Insolvency Lawyers' Association said:

[13] 23 (82%) agreed and five neither agreed nor disagreed, but made other comments. No consultees disagreed with the proposal.

> retail businesses marketing a scheme to consumers as a "saving" scheme (and which consumers would understand as a "saving" scheme) should be subject to the same requirements as those providing financial services.

A STRONG CASE FOR REGULATING

5.29 The responses we received have reaffirmed our view that when consumers make payments as a form of saving, regulation should ensure that those payments are protected. Below, we consider how such products might be defined for the purposes of regulation, and how that regulation might be effected.

Defining the relevant "savings" schemes

5.30 For regulation to be effective, it is necessary to have a robust definition of what constitutes a savings scheme. In 2006 when the OFT argued against specific regulation of the Christmas hamper sector, this was partly due to difficulties of definition. As the OFT put it, incorrect definitions could invite "either evasion or unintended consequences".[14]

5.31 Non-regulated savings schemes may take different forms. They may, as Farepak did, take monetary instalments in return for goods and/or vouchers provided at the end of the saving period. They may take the form of gift or loyalty cards on which a balance can be built up over time. However, a consumer might also pay a series of deposits or by instalment in advance of receiving the relevant goods or services. We do not consider that this arrangement would fall within our view of a "savings" scheme if it is more obviously a prepayment or series of prepayments for the goods or services, rather than a savings mechanism. This causes difficulty when trying to describe the defining characteristics of a savings scheme.

5.32 We agree that it is not possible to define a savings scheme by looking at the form it takes. Instead the focus must be on how it is perceived by consumers. The danger posed by unregulated "savings" schemes is that consumers think of them as suitable for saving in place of, for example, a dedicated bank account. In the Consultation Paper we suggested that "the definition should catch anything marketed or structured in a way that implies that it is suitable as a saving scheme".

5.33 On consultation, the Institute of Chartered Accountants of Scotland agreed with this approach, saying that:

> any scheme which implies or is explicit about a savings element should be captured within the definition to be used.

5.34 The Competition and Markets Authority, however, expressed concerns:

[14] Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006), para 9.

It seems likely to give rise to arguments as to what does and does not amount to a suggestion that a scheme can be used as a savings vehicle.

5.35 We have thought in more detail about the definition. We still think that the distinctive factor in savings schemes, which distinguishes them from other voucher retailers, is consumer perception. However, we now think that regulation should cover any scheme which takes consumer prepayments in return for goods, services, or vouchers, and which:

(1) is marketed as being suitable as a savings mechanism; or

(2) would be understood by "an average consumer" as being a form of savings.

5.36 This definition is in two parts. The first limb would cover the examples at the beginning of this chapter: the travel company which advertised its gift cards as "a great way to save" towards a holiday, and the toy shop which described its re-loadable gift card as a "piggy bank". There would be nothing to prevent these firms from continuing to sell these products without safeguarding the funds, provided that they removed all references to "saving" and "piggybanks" from their marketing material.

5.37 The second limb covers schemes where the association with saving goes deeper than anything which may or may not be said in the marketing material, and is inherent in the way that the scheme is structured. It is based on the understanding of the "average consumer". The average consumer test is commonly used in consumer law to signify a hypothetical consumer who is reasonably circumspect and well-informed.[15] It is therefore a relatively high threshold, which would not depend on misguided or misinformed perceptions.

5.38 We think that Christmas clubs would clearly fall within the second limb, because they are generally (and reasonably) perceived as a way of saving for Christmas, even if this is not explicitly mentioned in the marketing material. The second limb would also apply to other schemes which encourage consumers to build up a balance over time, especially where they can only be spent at a specified date. An example might be a travel voucher where consumers were encouraged to add to the balance over a six month period, and could not use their voucher until the summer.[16]

[15] For example, Consumer Rights Act 2015, s 64.

[16] In this example, the requirement to protect the money would not be especially onerous as travel operators are already required to protect consumer deposits: for further details see Apx D of the Consultation Paper.

The type of protection

5.39 Businesses should be given a choice about how to protect payments, which may be either by trust, insurance or bond. We envisage that most businesses would opt to hold consumers' money on trust. The CPA code of practice states that the trust must be overseen by trustees, half of whom must be independent of the member. We think a similar provision should apply here.[17] The trust would need to hold funds sufficient to cover the value of the goods or services ordered, ensuring that they can be delivered as promised. If provision of the goods or services would not be practical, because of the nature of the scheme or the business itself, then the trust should cover all prepayments made by consumers.

5.40 Insurance may also be an option, particularly if there was an industry drive for this solution.[18] Businesses could also use a combination of these options, with some funds held in trust and insurance on the balance, allowing the business to draw down some of the funds.

Cross-over with Electronic Money Regulations 2011

5.41 It is possible that some "savings" schemes which involve prepaid or reloadable cards would also be covered by the Electronic Money Regulations 2011 (EMR).[19] "Electronic money" is defined as electronically (including magnetically) stored monetary value.[20] The EMR already require the issuer to safeguard funds received in exchange for the electronic money issued.[21] This may be achieved through segregation of the funds (through ring-fencing in a separate bank account or through investment in low-risk assets) or through insurance.[22]

5.42 Schemes which are already covered by the EMR would not be affected by this change: issuers of e-money are regulated by the FCA, and the money is already protected.

[17] An example of such requirements in legislation appears in art 60 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 in the context of protection of funds for prepaid funeral services, which we discuss below.

[18] For a further brief discussion of the costs and availability of insurance, see Apx C, from para C.28.

[19] Discussed in more detail in the Consultation Paper, from para 7.35.

[20] EMR 2011, reg 2.

[21] EMR 2011, reg 20.

[22] EMR 2011, regs 21 (segregation) and 22 (insurance). The Treasury noted in 2010 that there was, at the time, no insurance option in the United Kingdom: see the minutes of the first meeting of the 2EMD Stakeholders' Liaison Group (April 2010), available here. We do not know whether this continues to be the case.

5.43 However, the EMR apply only to a small minority of electronic cards, which can be used in a wide variety of outlets and for a wide variety of goods. Most cards and vouchers are exempt from the EMR, either because they are not electronic, because they can only be used on the issuer's premises, or because they fall within the "limited network exemption".[23] Our recommended regulation of savings schemes would have an impact where these EMR-exempt cards are used as part of a savings scheme.

Smaller retailers

5.44 Several consultees were concerned about the potential impact of regulation on small and micro businesses, such as local butchers who operate a Christmas club. R3's Scottish Technical Committee said:

> In our experience, smaller retailers may be offering a "savings scheme" as a benefit or selling point, with the best of intentions and in good faith to support their communities and customer base.

5.45 Similarly, PwC said:

> Small local retailers may suffer, and their communities [may then be] unable to access goods and services that they have come to rely on over many years. Consistent communication using a number of different bodies would be required to ensure all such businesses were made aware, and standard wording provided for them to use with their customer base. Information would need to be provided to potential consumers as to why the service could no longer be provided but in such a way that it did not bring into question the current solvency of the retailer concerned.

5.46 However, Louise McDaid from the Farepak Victims Support Group commented:

> Additional costs would vary depending on the size of the business. Supermarkets have the means to pick up the costs as your local butcher might struggle but then why should they take our money all year if they are unable to ensure we get it back!

5.47 We have not consulted separately on the impact on small and micro businesses. However, we can see that they may find the costs of trust or insurance arrangements prohibitive. It is not uncommon to exclude microbusinesses from measures regulating business. We think there is a case for excluding schemes run by microbusinesses which take only small sums from consumers.

5.48 The most commonly used definition of microbusiness comes from the European Union, which defines a microbusiness as one which has fewer than ten employees and a turnover or balance sheet total of less than €2 million.[24] There are often good reasons to exclude such small enterprises from regulation.

[23] For further discussion, see Consultation Paper, from para 7,39.

[24] EU recommendation 2003/361.

5.49 However, to allow a microbusiness to take large sums from consumers, perhaps building them up over several months, without taking steps to protect them leaves scope for serious losses. We think therefore that any exclusion for microbusinesses should be limited to small prepayments – above a certain level, they should be protected. We suggest £100.

5.50 We recommend that the Government excludes schemes run by microbusinesses which do not take more than £100 from any individual consumer.

HOW REGULATION WOULD OPERATE

5.51 The next question is what form such regulation would take, and how it would operate. We have looked carefully to see whether any existing legislation could be amended to include savings schemes. In the Consultation Paper we suggested that an amendment to the Consumer Protection from Unfair Trading Regulations 2008 might be a viable way forward. In response to consultation feedback, we also investigated whether the arrangements for prepaid funerals could be used as a model. As discussed in Chapter 3, the provision of funeral plans is a regulated activity subject to FCA supervision, with an exemption for plans which protect the prepayment through insurance or a trust. We now think that neither of these models would be appropriate, for the reasons set out in in Appendix C.[25]

5.52 It would be difficult for Government to respond to a need to regulate consumer prepayments in this sector (or indeed in other sectors) without primary legislation. Given the delay and complexities involved in legislating for each problem sector, this points to a wider problem. We think that the Government should have the power to act quickly to require protection of consumer prepayments in problem sectors.

5.53 As described in more detail in the next chapter, we now recommend that the Government should take a regulation-making power to enable it to require protection of consumer prepayments in individual sectors when they are shown to pose a significant risk to consumers. We think that the first use of this new power should be to protect consumer prepayments in the "savings" schemes we have been discussing here.

Enforcement

5.54 Should the Government take action to require providers of "savings" schemes to protect prepayments, adequate enforcement mechanisms would be required to ensure that this action was meaningful. In Chapter 6 we discuss the general ways in which mandatory protection of consumer prepayments could be enforced. As with most consumer protection legislation, Trading Standards would be the most obvious principal enforcer.

[25] From para C.2.

5.55 However, Trading Standards cannot shoulder the full burden at a time of few resources and diminishing funding. In other sectors in which there is mandatory prepayment protection, the relevant trade bodies play an active role in monitoring compliance – notably ABTA in the travel sector and the Funeral Planning Association for prepaid funeral plans. We think this model could be echoed in the savings scheme market. We hope that the Christmas Prepayment Association could play an important role in ensuring compliance by its members (which it currently does). It could also help in identifying providers of similar schemes which are not members, and informing enforcers about possible problems. There may also be a role for the Advertising Standards Authority in terms of identifying products which are marketed as savings schemes.

RECOMMENDATIONS

Recommendation 1a: Legislation should apply to any scheme which takes consumer prepayments in return for goods, services, or vouchers, and which:

(1) is marketed as being suitable as a savings mechanism; or

(2) would be understood by the "average consumer" as being a form of saving.

Recommendation 1b: The legislation should require consumer payments to such schemes to be adequately protected, for example through trust arrangements or insurance. The protection should be sufficient to ensure that the promised goods, services or vouchers can be provided.

Recommendation 1c: The legislation should be made under the new regulation-making power recommended at 2a.

Recommendation 1d: Schemes run by microbusinesses which do not take prepayments of more than £100 from an individual consumer should be excluded from regulation.

5.56 The impact of this recommendation is discussed in Appendix B.

CHAPTER 6
A POWER TO REQUIRE SECTOR SPECIFIC PROTECTION

INTRODUCTION

6.1 Consumers can face losing prepayments in the event of a business' insolvency in a huge variety of circumstances – from £10 or £20 average loss for CD or DVD vouchers to thousands of pounds for a car or new build house deposit. This makes it difficult to draw general conclusions about the hardship suffered and the need for action to improve the position of consumers. We increasingly think that there may be a need for a sector specific approach.

6.2 In Chapter 3, we discussed existing sector specific arrangements for protection of consumer prepayments. Both industry-led voluntary codes and mandatory protection play an important role in protecting prepaying consumers. However, there are limits to the effectiveness of voluntary arrangements. Protection of prepayments is a major cost to businesses and many are reluctant to sign up to voluntary codes which require it, or may withdraw from a code when they begin to suffer financial difficulties. In sectors where there is particular risk of consumer detriment, regulation may be required to compel the industry to take action.

6.3 Mandatory protection of prepayments should only be considered where the risk of consumer detriment in a particular sector justifies it, and where it can be introduced without disproportionate cost. With the exception of Christmas and similar "savings" schemes, we have not identified any other sectors in need of immediate regulation. However, where particular risks are identified and intervention is justified, we think it is important that the Government can act quickly to require protection of prepayments in the relevant sectors. Below, we recommend that the Government takes regulation-making powers for this purpose.

THE LIMITS OF VOLUNTARY PROTECTION

6.4 For many years, the Government has encouraged, and relied on, industry-led voluntary protection of consumers in particular sectors which have been shown to pose a particular risk to consumers. As we discuss in Chapter 3, there have been a few success stories. In general, however, voluntary schemes only attract good businesses. Their efforts are too easily undermined by less scrupulous traders, even in sectors where consumer prepayment protection is widely offered on a voluntary basis.

6.5 Protection of prepayments is often one of the requirements in voluntary codes that retailers find most difficult to meet and may be the factor which dissuades businesses from signing up to, or remaining a subscriber to, a particular code.[1] Protecting prepayments has costs. Trusts can be administratively expensive and burdensome and deprive businesses of much needed working capital. Insurance and bonding schemes may be costly and difficult to obtain outside of established sectors. Where businesses do undertake to protect prepayments, the costs are inevitably passed to consumers.

Can voluntary protection be made easier?

6.6 In Chapter 10 of the Consultation Paper we considered ways to make voluntary protection less onerous for the businesses involved. On trusts, we looked at the possibility of partial trusts which would protect a proportion rather than the whole of each prepayment. We also asked whether it would be useful to develop standard trust deeds. On insurance, we asked what could be done to encourage the development of suitable insurance products. Finally, we floated the possibility of a voluntary "consumer charge", which would have some of the benefits of a trust without depriving the business of working capital.

6.7 We report the responses to these questions in Appendix C.[2] Disappointingly, only a few people thought that our suggestions would help. Most respondents argued that the costs and difficulties were inherent in the nature of the protection and could not be mitigated. Given the responses we received, we are no longer pursuing this line of enquiry.

MANDATORY PROTECTION IN SOME SECTORS?

6.8 Because of the limitations of voluntary protection, the threat – or actual introduction – of regulation may be needed to ensure that comprehensive and effective action is taken to protect prepayments.

6.9 For example, we were told that there is a particular need for industries to take concerted action to overcome the barriers to obtaining insurance and to provide sufficient claims data to establish a thriving market. This action might be encouraged even by a threat of regulation which could be avoided if adequate insurance arrangements were put in place on a voluntary basis. In other cases, actual regulation may be necessary to ensure a level playing field between businesses, bringing poor businesses up to the same standards of consumer protection as good ones.

6.10 Consumer Focus has put a strong case for legislating for "reserve powers" which would allow the Government to regulate high-risk industries if the need arose:

[1] See from para 3.39.

[2] From para C.14.

> We are attracted by the idea of giving the Secretary of State a reserve power to impose prepayment protection in specific sectors as required where there is evidence of demonstrable need ... This backstop would provide an incentive for recalcitrant industries to act voluntarily and enable swift action in emergency situations.[3]

6.11 In Chapter 11 of the Consultation Paper we weighed the arguments for and against requiring consumer prepayment protection by regulation.

6.12 One argument against regulation is the difficulty of identifying and defining sectors which pose particular risks to prepaying consumers. And of course, the costs and other difficulties associated with protecting prepayments still apply when protection is mandatory. These issues may make some businesses working on very slim margins unviable – although industry wide demand for insurance should lead to more affordability.

6.13 It is a difficult balancing act. In the Consultation Paper we said that regulation was justified if there was clear evidence of risk, but it should not impose undue costs or bureaucratic requirements on well-run businesses, particularly since these costs are inevitably passed to consumers.

Rapidly changing consumer markets

6.14 Consumer markets are developing quickly. The Government has a broad commitment to encourage competition and open up markets to new entrants. Examples of growing markets which we have encountered during the course of our project include energy providers, payment services providers and providers of warranties for new build homes. While increased competition offers many benefits for consumers, it may also increase the risk of insolvency. New entrants may be less experienced and less well capitalised, and may seek to undercut established retailers in the market by offering lower levels of prepayment protection.

6.15 While we support the benefits of increased competition, we think it should be allied to a power to respond quickly to increased risks of losses on insolvency if the need arises.

Identifying sectors where protection is needed

6.16 So far we have identified Christmas and similar “savings” schemes as justifying immediate attention but there may be other sectors where intervention is required – we listed the sectors which were concerning stakeholders in Chapter 4.[4]

[3] S Brooker for Consumer Focus, *Pay now, pay later: consumer prepayments and how to protect them* (August 2009) p 39.

[4] From para 4.67.

6.17 It is extremely difficult to identify where another large insolvency might occur. In the Consultation Paper we suggested that the Government should take reserve powers to regulate high-risk voucher intermediaries which hold significant funds for long periods. However, as we explain in Appendix C,[5] we no longer think that there is a case for singling out that sector for intervention. If there is to be a power to require protection of prepayments, it should be in general terms.

6.18 There are several reasons why a sector may pose particular risks. The nature of the product or service may mean that significant prepayments are held for long periods of time. The risks are compounded where consumers do not pay by credit or debit card, but by other methods which do not offer protection. Examples may be paying utility bills by direct debit or house deposits by bank transfer.

6.19 Some forms of loss may also cause particular hardship. One reason for the outrage caused by the Farepak insolvency was that families were left without money for their Christmas celebrations. Another example would be if older consumers overpaid for fuel bills in the summer and were then unable to afford winter fuel following a provider's insolvency.

Concerns about reserve powers

6.20 One key argument against a reserve power is that it is likely to be used "to shut the stable door after the horse has bolted". Jessica Morden MP said that the only way a case could be made to regulate a sector would be in the wake of another business collapse, which would be too late.

6.21 It is true that sector specific regulation is likely to be introduced as a response to insolvencies in a sector and that the consumers affected by those events would not benefit from any regulations which were introduced subsequently. However, this is not a reason not to protect future consumers in that sector. Enacting secondary legislation under a power should be a far quicker process than primary legislation, capable of reacting relatively quickly and mitigating the "stable door" argument.

6.22 Another concern was that it would by-pass Parliament. The Institute of Chartered Accountants Scotland said that the case for legislation affecting a particular sector should be made out at the time measures were to be introduced. However, primary legislation can be months or years in the making. We think that Government should have a power to react more quickly to an emerging risk. Secondary legislation would still need to be justified.

6.23 The Competition and Markets Authority was concerned about a sector specific approach:

> Any sector where consumers routinely pay large sums in advance, or where they make payments a long time before they receive goods or services, may become 'high risk' for consumers in the event of changes to trading conditions that threaten the stability of the individual businesses or sectors concerned.

[5] From para C.46.

> We consider that proposals that address general principles rather than sector-specific issues may (particularly recognising the pace of market change) be more likely to provide effective solutions across the board, and also provide the most effective method of future-proofing.

6.24 We agree that sector specific protections are not the whole solution, but think they should be part of the Government's armoury. In Chapter 8 we discuss a limited change to the order of payments on insolvency which would apply across all sectors.

A POWER TO REQUIRE SECTOR SPECIFIC REGULATION

6.25 We therefore recommend that the Government takes a power in primary legislation which enables the Secretary of State to make regulations requiring protection of consumer prepayments in any sector. It should be exercisable where, in the opinion of the Secretary of State, the sector poses particular risk to prepaying consumers.

6.26 We would envisage that the power would also set out:

(1) the types of protection which would satisfy a requirement for protection of prepayments; and

(2) the general remedies against a business in a relevant sector failing to protect the prepayments, and the manner of enforcement.

Types of protection

6.27 We think that any legislation should allow for protection of prepayments in a variety of different ways. This is the approach of the Package Travel Regulations 1992,[6] which permit the required protections to be provided through bonding with an approved body, insurance or trust accounts. Bonding, insurance and trusts were the three main methods of protection which we identified in Chapter 3 and we would envisage that legislation would follow this precedent.

6.28 We think any trust should be required to have at least one trustee who is independent of the company.[7]

Enforcement

Enforcement in other consumer legislation

6.29 We have looked at the Package Travel Regulations as a precedent for how obligations to protect consumer prepayments should be enforced. A failure to protect prepayments in breach of those Regulations is a criminal offence, punishable by a fine.[8] The offence is subject to a due diligence defence.[9]

[6] Package Travel, Package Holidays and Package Tours Regulations 1992, regs 17 to 21.

[7] As required by art 60 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 in the context of protection of funds for prepaid funeral services.

[8] Package Travel, Package Holidays and Package Tours Regulations 1992, reg 16(3).

6.30 The obligation is enforced by local authority Trading Standards, which have a duty to enforce the provisions within their area. Typically, each authority has an enforcement policy which will lay out what they will do to ensure that any action taken is fair and proportionate.[10] In addition to prosecution, Trading Standards have civil enforcement powers under the Enterprise Act 2002. They can, for example, accept undertakings[11] or apply to the court for an enforcement order.[12]

6.31 Trading standards also have powers to investigate under Schedule 5 to the Consumer Rights Act 2015. These include a power to require the production of information,[13] and power to enter premises without a warrant.[14]

6.32 Under other consumer legislation, the Competition and Markets Authority and other regulators also play a role. For example, under the Consumer Protection from Unfair Trading Regulations 2008, the CMA has a power (but not a duty) to enforce the Regulations. It focuses on market-wide problems or issues that affect consumers' ability to make choices.[15]

6.33 For unfair terms legislation, there are 11 enforcers who may take proceedings, including the Office of Communications (Ofcom) and Office of Gas and Electricity Markets (Ofgem).[16]

Enforcement of any new regulations

6.34 As with the Package Travel Regulations, we think that it should be a criminal offence to breach an obligation to protect prepayments.

6.35 Again, Trading Standards would be primarily responsible for enforcement. In addition to the power to prosecute, Trading Standards would have civil enforcement powers under the Enterprise Act 2002. They would also have investigatory powers under Schedule 5 to the Consumer Rights Act 2015.

6.36 It would be helpful for the CMA and other regulators to also play a role. For example, if prepayments for gas or electricity were to be identified as a sector in need of protection, we think that Ofgem should be the primary enforcer. If broadband supply were identified as an issue, it would be Ofcom.

[9] Package Travel, Package Holidays and Package Tours Regulations 1992, reg 24.

[10] Business Companion, *Trading standards – inspections & powers*, last updated in October 2015. Available here. Trading Standards do not have powers to shut down a business.

[11] Enterprise Act 2002, s 219.

[12] Enterprise Act 2002, s 215.

[13] Consumer Rights Act 2015, sch 5, para 14.

[14] Consumer Rights Act 2015, sch 5, para 23.

[15] Competition and Markets Authority, CMA7, *Consumer Protection: Guidance on the CMA's approach to its use of consumer powers* (March 2014), paras 1.2 to 1.5.

[16] Consumer Rights Act 2015, sch 3, para 8.

RECOMMENDATIONS

Recommendation 2a: The Secretary of State should have a power to require protection of consumer prepayments in sectors which, in the opinion of the Secretary of State, pose significant risk to consumers.

Recommendation 2b: Legislation should allow for prepayment protection by trust, insurance or bonding or a combination thereof.

Recommendation 2c: Any regulations made should be enforced by Trading Standards and the Competition and Markets Authority by civil or criminal measures.

CHAPTER 7
CHARGEBACK

7.1 A consumer who has paid by credit or debit card for undelivered goods has the ability to recover money through their card issuer. In practice, this is a major source of protection against retailer insolvency. Debit and credit cards are now by far the most common form of payment.[1] Our analysis of retailer insolvencies shows that, following a major high street collapse, card issuers often make refunds to consumers totalling several million pounds.[2]

7.2 Consumers use cards in shops and online on a daily basis but may have little idea of the complex arrangements which sit behind each transaction. We therefore start by describing the card cycle. We then summarise the two main methods by which consumers may seek refunds: the statutory right under section 75 of the Consumer Credit Act 1974; and the voluntary protection provided by card schemes' "chargeback" rules.

7.3 These protections are a crucial way to underpin consumer confidence. However, the chargeback scheme needs to be better known and understood. We therefore recommend changes to increase information about chargeback. We also raise concerns about new payment methods which may provide less protection to consumers.

THE CARD CYCLE

7.4 A typical card transaction involves five separate entities. The consumer is connected with the retailer through their card issuer, the card scheme and the merchant acquirer. The entities are:

(1) The consumer who pays by card (the "**card holder**").

(2) The bank or building society that issues the card (the "**card issuer**"). 27 card issuers are members of the UK Cards Association, though more exist.

(3) The **card scheme**, which sets the rules governing card payment transactions between the card issuer and the merchant acquirer. Visa and MasterCard are the most commonly used card schemes in the United Kingdom.

[1] In March 2016, 77.4% of national retail sales were made by card, with a split of 53.5% by debit card and 23.9% by credit card: see UK Cards Association, *Card Expenditure Statistics* (March 2016) p6. Available here.

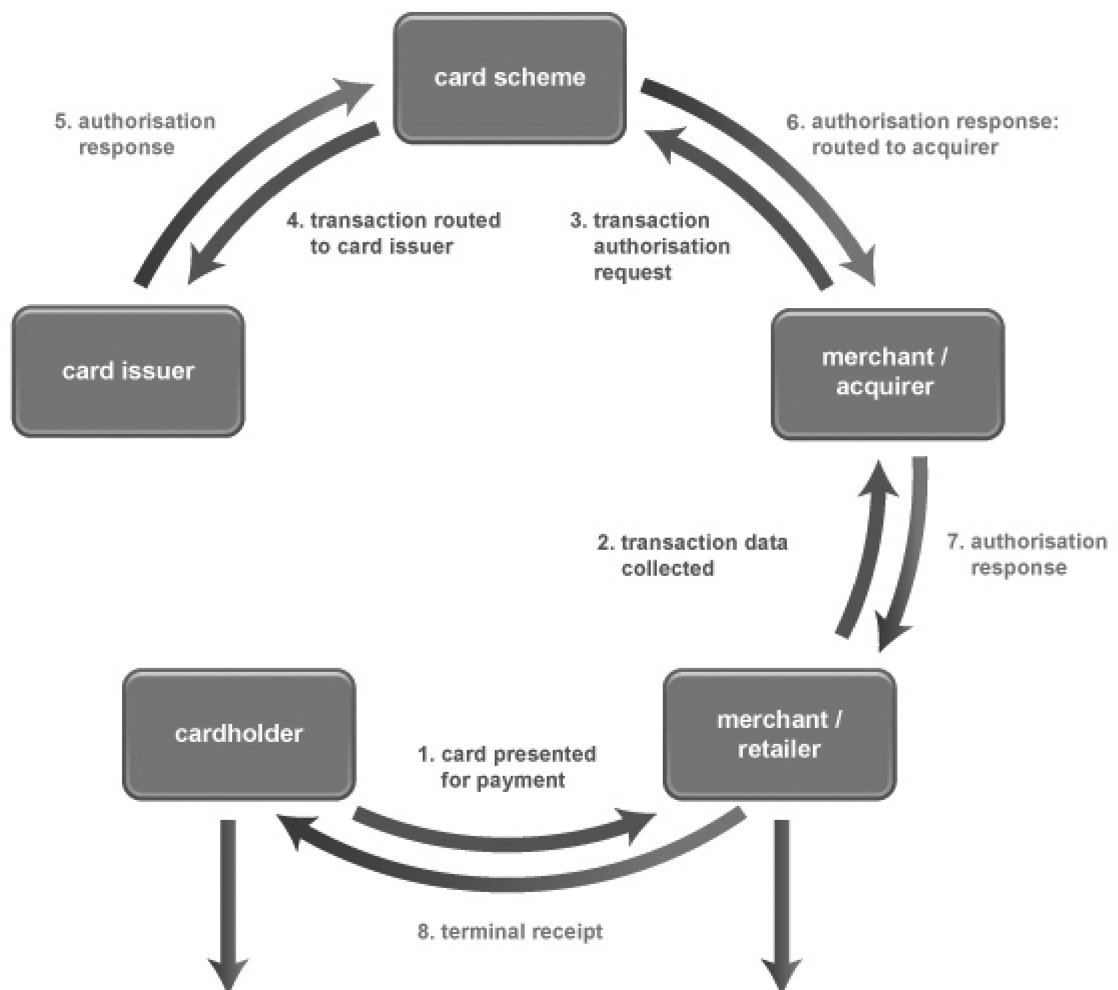
[2] Estimates put the figures at £2.58 million for Homeform, £2.1 million for Comet and £1.1 million for Land of Leather. Even in the smaller insolvencies we examined, it provided important redress for consumers with 40% of prepayments in Underwood Retail recovered in this way and 34% in Lusso UK.

(4) The **merchant acquirer**, which contracts with the retailer (or "merchant") to process payments. Sometimes called "merchant services providers", they used to be associated with the major banks. However, as the market has become more competitive, they have become increasingly independent. Merchant acquirers in the United Kingdom include WorldPay, Barclaycard Merchant Services, Elavon, and Lloyds Bank Cardnet.

(5) The **retailer**, which is seeking payment from the consumer.

A typical card transaction

7.5 The following diagram[3] illustrates a typical card transaction:



7.6 The consumer initiates a card transaction by inserting their card into a retailer's terminal and entering their PIN. Alternatively, they may present a contactless card, or enter card details online. The transaction is then passed electronically from the retailer to the retailer's merchant acquirer. In turn, the merchant acquirer directs the transaction through the card scheme (usually Visa or MasterCard) to the card issuer for approval. If the transaction is approved, an authorisation response is sent back instantaneously to the retailer's terminal, via the card scheme and the merchant acquirer.

[3] Reproduced with the kind permission of the UK Cards Association. See it on the UK Cards Association website here.

7.7 The amounts owed by each card issuer to the various merchant acquirers are reconciled on a daily basis. The merchant acquirer will then release funds to the retailer, according to the terms of their contract. Where delivery of goods is immediate, such as in a coffee shop, the acquirer will pass on funds quickly. However, where there is a long period between payment and delivery (for example with an airline), acquirers may hold back substantial sums to balance the risk of potential chargeback claims. Merchant acquirers will increase the amount of collateral held back if the retailer appears to be experiencing financial difficulties. When the airline Flyglobespan entered administration, its merchant acquirer was holding £35 million of collateral.[4]

7.8 The payment cycle relies on a chain of separate legal relationships. The consumer agrees to the card issuer's terms and conditions. The retailer enters a contract with the merchant acquirer to process payments. Meanwhile, the relationship between the merchant acquirer and the card issuer is governed by the "scheme rules" set by Visa and MasterCard. Neither the consumer nor the retailer is a party to these rules.

PROTECTION FOR CARD PAYMENTS

7.9 There are two main ways in which payments by card are protected:

(1) For credit card transactions where the goods or services cost more than £100 and less than £30,000, section 75 of the Consumer Credit Act 1974 renders a card issuer jointly and severally liable for the retailer's breach of contract and/or misrepresentation.

(2) For all types of card transactions, including those made by debit as well as credit card and irrespective of the value of the transaction, the card schemes provide a system of "chargeback", which allows the card issuer to ask the merchant acquirer to reverse a payment made by card.

A comparison between section 75 and chargeback

7.10 Full descriptions of section 75 rights and the chargeback scheme are set out in the Consultation Paper.[5] They share a similar procedure, but there are some important differences. Table 3 below summarises the main similarities and differences.

[4] The Globespan Group plc (in administration), *Joint administrators' progress report for the six months ended 15 December 2014*, p 2. Available here.

[5] Consultation Paper, Ch 5.

Table 3: Summary of section 75 and chargeback

	Section 75 of the Consumer Credit Act 1974	**Chargeback**
Nature of protection	Statutory right.	Contained in card scheme rules issued by Visa and MasterCard, to which the consumer is not party.
Type of card	Credit cards only.	Credit and debit cards.
Value of prepayment	Value of goods or services must be over £100 and less than £30,000, though the amount paid on card may be less.	No minimum or maximum limits.
Amount which can be recovered	Total value of prepayment, irrespective of how much was paid by credit card. Any consequential loss may also be claimed as damages.	Amount paid by card.
Claim to be made to	Card issuer.	Card issuer.
Time limit for making a claim	Statutory limitation rules apply. Six years from the non-delivery of goods or service (five years in Scotland).	The time limits are set out in the scheme rules. Generally the card issuer must raise a claim within 120 days of the date on which delivery of the goods or services was expected.
Where retailer is insolvent, who bears the loss	Card issuer (unless offset by chargeback claim against merchant acquirer).	Merchant acquirer.

A similar procedure

7.11 A consumer who realises that prepaid goods or services will not be supplied can contact their card issuer and request a refund. The card issuer will ask for supporting documentation and examine the request.

7.12 If the card issuer accepts the consumer's request, it will refund the amount at stake to the consumer through the relevant card. Even if the claim qualifies as a section 75 claim, the card issuer will then consider whether to recover the money from the merchant acquirer under the chargeback procedure set out in the card scheme rules. We have been told that for small amounts (under £10) the card issuer may decide to absorb the loss. However, card issuers can use the chargeback procedure whatever the sum at stake.

7.13 If it decides to try to recover the money, the card issuer transmits a chargeback through the card scheme to the merchant acquirer. The scheme rules set strict time limits for card issuers to submit chargeback claims. Generally, the chargeback must be submitted within 120 days from the date on which the consumer expected to receive the goods or service. There is also a 540 day longstop deadline which runs from the transaction processing date.

7.14 Where the retailer is still in business, the merchant acquirer will contact the retailer to allow it to challenge the chargeback. Unless the retailer can demonstrate that the chargeback is not justified, the merchant acquirer will generally deduct the amount of the chargeback from the funds it holds for the retailer. However, where the retailer is insolvent, the acquirer may end up bearing the loss. Merchant acquirers therefore take steps to hold back funds ("collateral") from retailers to meet this liability. These steps will be governed by the contract between the acquirer and the retailer and depend on the acquirer's assessment of the risk of the retailer's insolvency.

Points of difference

Basis of the consumer's claim

7.15 Section 75 gives consumers a legal claim against the card issuer, irrespective of whether the card issuer is able to claim the money back through the card scheme rules. By contrast, those who fall outside section 75 have no legal rights in this regard. Card issuers will often refund prepayments to those who use a debit card rather than a credit card – or to those who use a credit card for purchases outside the financial limits – but they have no statutory obligation to do so.

7.16 That said, all consumers who have been refused a refund have an avenue of redress. Consumers who are unhappy with their card issuer's decision are entitled to complain to the Financial Ombudsman Service (FOS). The FOS has the power to require banks to pay up to £150,000 in compensation and is not bound by the letter of the law. Instead, ombudsmen are directed to determine complaints "by reference to what is, in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case".[6]

7.17 In 2009, the FOS published a short description of how it deals with consumer complaints about chargeback. It explained that chargebacks are not consumer rights provided by law and consumers are not generally aware of the circumstances in which chargeback might be attempted. However, the FOS said:[7]

> We expect card issuers (who should understand the terms and conditions of their own contracts with the network providers) to consider making a chargeback claim if the consumer has made them aware of a situation where this might be appropriate.

[6] Financial Services and Markets Act 2000, s 228.

[7] Financial Ombudsman Service, *Ombudsman News* (issue 78 July/August 2009). Available here.

7.18 In practice, the FOS requires card issuers to deal with disputed transactions fairly, within the terms of chargeback provisions set out in the scheme rules. The FOS has confirmed that, in the case of a retailer insolvency, it is prepared to require a card issuer to compensate a consumer if it has unreasonably refused to refund money which it could have recouped through a chargeback claim.

7.19 The approach of the FOS therefore means that chargeback arrangements are not as voluntary as first appears.

Time limits

7.20 For those making a claim under section 75, the chargeback time limits are not a primary concern as the limitation period for breach of contract applies[8] (generally six years in England and Wales and five years in Scotland).[9] However, consumers who fall outside section 75 and are reliant on chargeback are unlikely to receive a refund unless they act quickly, within the time limits set by the scheme rules.

7.21 Importantly, the 120 day limits are for the card issuer to submit a chargeback claim to the merchant acquirer. In practice, the consumer should contact their card issuer earlier – typically within 90 days of non-delivery – so that the card issuer has time to consider whether a chargeback claim is appropriate.

7.22 Given the importance of the time limit, we think consumers need more information about how it operates. We return to this issue below.

The amount of the claim

7.23 Finally, section 75 provides the consumer with the same claim against the credit card issuer as they would have had against the retailer. This is a wide right: if a consumer paid a £150 deposit for a holiday which was not delivered, of which £50 was by credit card and the rest was in cash, the consumer may claim the full £150 against the card issuer. And if the holiday was misrepresented, in a way which would have given the consumer a compensation claim against the retailer, the credit card issuer is also liable to pay compensation.

7.24 However, for claims which fall outside the section 75 parameters, the voluntary chargeback refund is limited to the money paid through the card.

THE IMPORTANCE OF CHARGEBACK PROTECTION

7.25 UK consumers have a particularly high rate of card use. On average, each UK resident makes 175 card transactions per year - fewer than consumers in Sweden, but many more than in other European countries such as Germany, Italy or Belgium.[10]

[8] This is because s 75 provides that in a creditor-debtor-supplier relationship, a debtor (here the prepaying consumer) who has a claim against a supplier for misrepresentation or breach of contract shall have a like claim against the creditor (here the credit card issuer). The creditor, with the supplier, is jointly and severally liable to the debtor.

[9] Limitation Act 1980, s 5 (for England and Wales); Prescription and Limitation (Scotland) Act 1973, s 6 (Scotland).

[10] UK Cards Association, *UK Card Payments 2015*, p 53.

7.26 In the UK, credit and debit cards are the dominant means of internet purchase. Unlike in the Netherlands, it is rare for a UK consumer to pay for an online purchase by direct transfer from their bank account (such as via BACS or CHAPS).[11] And unlike in India, Russia or Poland, it is extremely rare to pay for internet purchases through cash on delivery.[12] Instead, UK consumers are particularly likely to see credit cards as the safest way to pay for an online purchase.[13] MasterCard told us that consumers in the United Kingdom make proportionately higher use of the chargeback scheme compared to those in other EU countries.

7.27 UK consumers are also particularly confident internet shoppers. Compared with other EU countries, more consumers buy online, spending larger sums with a greater variety of retailers.[14] In the Consultation Paper we suggested that these various factors were linked. Cards (and the protection cards bring) underpin UK consumer confidence in prepaying for goods, both online and in shops.

7.28 In practice, the chargeback system may result in considerable sums being refunded to consumers. Following the MFI insolvency, for example, £19.3 million was refunded through chargeback.[15] Its existence is also relied on by other schemes. Even in sectors such as travel, where statutory protection is in place, consumers may first be required to contact their bank to raise a chargeback before relying on the industry protections.[16]

PRESERVING A VOLUNTARY SCHEME

7.29 Outside the confines of section 75, chargeback is voluntary at two levels. First, the process is included by the card schemes within their own rules and they could decide to restrict or remove them. Second, the rules govern the relationship between the card issuer and merchant acquirer and do not confer any rights on the card holder. It is for the card issuer to decide whether or not to raise a chargeback, not the card holder.

[11] UK Cards Association, *UK Card Payments* 2015 p 53.

[12] Nielsen Research Report, *Global Connected Commerce: Is e-tail therapy the new retail therapy?* (January 2016) p 19. Available here.

[13] One report suggests that 53% of UK customers believe that credit card payments for online purchases were the safest method of payment compared to 37% of US consumers: ‘Are customers in the UK naïve to the increasing threat of credit card data theft?’, *IT Governance Blog* (6 January 2015). Available here.

[14] Ecommerce Europe, *European B2C E-Commerce Report 2014*; “light” version available to download here. The Ofcom International Market Communications Report 2011 (p 207) found that 79% of internet users had bought goods online, more than in any other EC country. They had also spent more (at £939 per head).

[15] The administrator of MFI told us that of this £19.3m, approximately £15.3m related to non-delivery of customer orders. The remainder concerned claims for part-delivered orders and extended warranties.

[16] See Consultation Paper, para D.67 of Apx D and paras E.7 to E.8 of Apx E.

7.30 This leads to questions about whether the chargeback scheme should be put on a statutory footing. In the Consultation Paper we concluded that the case for legislative intervention had not been made out. We thought that the current system generally works well and would not be improved by regulation, which we thought should only be considered if the card schemes took steps to remove or lessen the voluntary scheme. Any legislation is likely to be limited in scope: for example, the Danish statutory scheme only applies to distance sales, while the Visa and MasterCard rules apply across the board. New statutory rules could simply introduce additional complexity into the scheme with little corresponding benefit.

7.31 Instead, we thought that the priority was to give consumers more information about the existing schemes.

Consultation responses

Agreement with a voluntary scheme

7.32 The great majority of respondents agreed with us that chargeback should remain voluntary.[17] This included consumer-focussed respondents, though they said that the situation should be kept under review and that regulation may be necessary if the protections it offers consumers were removed or weakened.

7.33 Several consultees echoed our thoughts that the current system worked well. As PwC said:

> Our experience in formal insolvency is that the chargeback system is effective and do not think further changes in the law are merited: rather the scheme needs to be more visible, and easier to access and use.

7.34 Respondents were concerned that introducing a legislative regime would have associated costs which would, inevitably, be passed on to the consumer. As the Society of London Theatre put it:

> Inevitably where legal compliance procedures are required to be put in place, there is likely to be a cost in meeting, checking and enforcing such obligations. We believe that any additional costs incurred by the card schemes involved in meeting these regulatory obligations would ultimately be passed on to the parties benefiting from the chargeback rights.

7.35 Respondents also suggested that a mandatory scheme might prompt merchant acquirers to withhold more collateral, thereby straining the cash flow of businesses. For example, the Insolvency Lawyers' Association said:

> There may in particular be a danger that imposing "new legal duties" could lead to merchant acquirers seeking to withhold more collateral (with consequential impact on the business' cashflow) to protect against such "legal duties".

[17] 22 (76%) of 29 consultees who responded on this point.

Concerns about a voluntary scheme

7.36 Only four respondents suggested that chargeback should be made mandatory. Moore Stephens thought that the scope of section 75 protection should be extended to cover all card payments. ABTA suggested that the growing popularity of debit cards and the development of new forms of mobile payment were likely to increase the importance of these protections.[18]

7.37 Some stakeholders suggested that greater consumer awareness of chargeback, leading to more claims, might cause card schemes and card issuers to withdraw the chargeback process. Although the card schemes could remove the process, Visa and MasterCard told us that they had no plans to do so, and it is clear that any threat of regulation is an incentive not to.

Conclusion

7.38 The responses we received have reaffirmed our view that legislation requiring chargeback should not be introduced. We think that the problems with the current process are with consumer awareness and transparency and that these can be improved by non-legal means.

7.39 That said, given the importance of chargeback, any moves to significantly reduce or remove the process could have a major detrimental effect on the entire retail sector. In these circumstances, the issue may need to be re-examined.

7.40 For the present, however, our recommendations concentrate on ways to improve information about chargeback and ensure it works more smoothly on retailer insolvency.

THE NEED FOR TRANSPARENCY

7.41 Despite the importance of chargeback, not everyone is aware that it exists, or knows how to use the system successfully.

7.42 In our analysis, we found examples of merchant acquirers holding funds substantially in excess of the eventual claims. For example, in the case of Comet, £9.4 million was held back, though chargeback claims totalled only £2.1 million; in the Land of Leather administration, £4.5 million was held back but only £1.1 million of chargeback claims were raised.

7.43 Although the reasons for the differences between the amount held back and the amount actually claimed are not entirely clear, it seems likely that under-claiming by consumers who could have made a chargeback claim is at least a contributory factor. Anecdotal evidence also suggests that many consumers are not aware that payment by debit card affords any such protection. We identified four areas in which we thought improvements could be made in order to ensure that consumers are in a position to pursue the option of chargeback should they wish to:

(1) initial information provided by insolvency practitioners;

[18] We discuss some new forms of payment, some of which do not offer chargeback or similar protection, below from para 7.93.

(2) information from card issuers;

(3) guidance on time limits for claiming; and

(4) reasonable evidential requirements.

Information from insolvency practitioners

7.44 Not all administrators tell consumers about the possibility of a chargeback claim. Some worried that telling consumers to ask for a chargeback could be seen as preferring one set of creditors at the expense of all creditors, which insolvency practitioners must not do.

7.45 It is true that consumers' chargeback claims can result in the merchant acquirer releasing less money back to the insolvent retailer's estate to be distributed to creditors as a whole. However, this does not mean that insolvency practitioners may not or should not draw consumers' attention to the possibility of making a chargeback claim, given that the arrangements already exist. Chargeback is a private arrangement between the card issuer and merchant acquirer, and the collateral is held specifically to meet card issuers' claims. The benefit of chargeback should not be reserved for those consumers who happen to know it exists. Most administrators consider it legitimate to inform consumers about the possibility of claiming. As discussed further below, we think that guidance issued by the Insolvency Service to insolvency practitioners could do more to reassure administrators on this point.

Information from card issuers

7.46 Card issuers do not always do enough to inform consumers about how and when to request a chargeback claim. In the Consultation Paper we commented that many card issuer websites give little prominence to chargeback. Although websites tend to mention refunds for fraud, they provide less information about the chargeback for non-delivery of goods and services.[19]

7.47 The problem is exacerbated by lack of consistent terminology. The card schemes tend to argue that "chargeback" is an internal matter between card issuer and acquirer. The consumer requests a refund rather than a "chargeback". Thus if a consumer searches the internet for information about chargeback from their bank, they will not always find the appropriate contact details. We think the scheme would be better known if the card issuers were more prepared to use the word chargeback in describing the scheme as it affects consumers.

[19] Consultation Paper, para 5.58.

7.48 Once a consumer has made initial contact with their card issuer, the success of the claim depends partly on the training given to the card issuer's staff. Research for Which? suggests that staff knowledge about chargeback is variable.[20] As we describe below, consumers may encounter problems with time limits and evidence requirements.

Time limits

7.49 Although some information is available about the 120 day time limit, consumers may not realise that they must contact their card issuer well before this date. They may also be confused about when the time limit starts.

7.50 A technical briefing from Grant Thornton explains when the 120 days starts to run in particular types of transaction.[21] For furniture or white goods, it runs from the expected date of delivery (or 30 days from the date of the transaction; whichever is the later). In the case of a service provided over a period, such as a football season ticket, a consumer must make their claim within 120 days of the end of the period. Where a concert is cancelled, the 120 day period runs from the date of the concert; and with holidays, from the planned date of travel.

Evidential requirements

7.51 Clearly, a merchant acquirer will want the card issuer to provide appropriate evidence to confirm that a chargeback situation has arisen, as required by the scheme rules. However, consumers are sometimes asked by their card issuer for information which they do not know how to obtain, or cannot obtain.

7.52 For example, consumers reported that they were often asked for "liquidation notices" as proof of the retailer's insolvency, though they struggled to know where to obtain these documents. In several cases, card issuers mistakenly told consumers to contact Trading Standards Services, who were unable to supply these.

> The goods were not delivered ... and I have since contacted my credit card to make a claim. They are sending me the relevant documentation to complete, and have requested that I also send a liquidation letter, which they informed me I could get from my local trading standards office. [Citizens Advice case histories]

7.53 The Insolvency Act 1986 requires all company websites to state that a business is being managed by an administrator and to give the administrator's name.[22] We think a link to the appropriate website should be sufficient to provide evidence of insolvency.

[20] Which? Press Office, 'Bank staff failing to explain card protection rules' (25 October 2014), available here. It should, however, be noted that conducting mystery shopping exercises in this area is problematic. When faced with a consumer enquiry regarding chargeback or section 75 protection, a card issuer will require information about the disputed transaction to determine the validity of the claim. As Which? is unlikely to have been in a position to provide this, the results should be treated with caution.

[21] Grant Thornton, *Technical briefing, Understanding and managing merchant acquiring risk* (2008).

[22] Sch B1, para 45.

7.54 Another problem is that consumers may be asked for written confirmation from administrators that goods will not be delivered, which may not be forthcoming.

> My credit card company is willing to accept a section 75 Consumer Credit Act claim but they need [trader] to confirm that they did not deliver the goods. [Trader] have confirmed on the phone that they will not be delivering the goods but refuse to put anything in writing, and the administrator also refuses to put anything in writing to me. Can the credit card company refuse to address this claim without written evidence?

7.55 It is not always possible for administrators to provide a definitive statement of whether goods will be delivered, particularly in the early stages of an administration, when the issues are still under consideration. There needs to be clearer guidance that a chargeback claim is available whenever goods have not been delivered on the agreed date (or within 30 days of the payment). If card issuers wait to see whether goods may be delivered in the future, there is a danger that the time limit for raising a chargeback may be missed.

CONSULTATION PROPOSALS

7.56 In our Consultation Paper, we put forward three proposals to improve transparency in this area:

(1) Insolvency practitioners should give information to consumer creditors about chargeback claims and make available on the retailer's website a confirmation that the company is in administration or liquidation.

(2) All card issuers should give consumers a brief explanation of how to raise a chargeback. This should include:

(a) Contact details (including a phone number and website address);

(b) Details of situations in which consumers may raise a chargeback, including when a retailer enters administration, and what documentation needs to be provided to the bank;

(c) A statement that consumers who think they have met with an unreasonable refusal may complain to the Financial Ombudsman Service.

(3) Card schemes should provide a publicly available authoritative guide on how chargeback works.

7.57 As we discuss below, the responses revealed overwhelming support for all three proposals.

Information from insolvency practitioners

7.58 We proposed that insolvency practitioners should provide consumer creditors with more information about chargeback. The vast majority of consultees who answered this question agreed with the proposal.[23]

7.59 Generally, respondents thought that this suggestion would be easy to implement and would not unduly burden insolvency practitioners. Deloitte said:

> The insolvency practitioner will typically set up a website for each insolvency appointment, as we currently do. These websites are populated by responsible IPs with general information such as validity of gift vouchers and other frequently asked questions. It would not be difficult to add chargeback information but that should not remove any responsibility on the part of either retailers or card providers to better publicise this facility and how it operates.

7.60 Several insolvency practitioners said that they already provide this information. KPMG added:

> We currently ensure that, where possible following our appointment, we give information on an insolvent company's website regarding the possibility of asking card issuers to raise a chargeback, along with other helpful frequently asked questions and answers for consumers. We agree that it would be helpful if this guidance were provided more widely by the profession.

7.61 The Finance and Leasing Authority commented that the information required from insolvency practitioners should be "high-level" and restricted "to the possibility of raising a chargeback":

> An insolvency practitioner will not be able to determine the likelihood of a successful chargeback in individual cases or be expected to comment on differences between chargeback schemes.

Conclusion

7.62 We welcome this agreement that insolvency practitioners should provide consumers with initial information about chargeback. Many insolvency practitioners already do this. Only a few have expressed concern that such information may amount to a preference, and we wish to remove any remaining concerns in this area.

7.63 We agree that the information should be high level. Providing this information should not be a burdensome task. We would expect insolvency practitioners to provide a prominent statement on the website informing consumers about chargeback, telling them to contact their card issuer. It would also be helpful to remind consumers to act promptly and provide a link to further information.

[23] 31 out of 34 (91%) of respondents agreed.

Method of dissemination

7.64 In the Consultation Paper we said we hoped that the Joint Insolvency Committee[24] (JIC) would draft a Statement of Insolvency Practice (SIP) requiring insolvency practitioners to provide consumer creditors with basic information about chargeback. The JIC felt that a SIP would not be appropriate: SIPs are focused more towards the interpretation of regulatory and statutory requirements and would not be suitable for the dissemination of general guidance.

7.65 In discussion with the JIC, it was suggested to us that the most appropriate vehicle for our proposals would be the Dear Insolvency Practitioner (Dear IP) newsletter. This is a quarterly newsletter issued by the Insolvency Service to insolvency practitioners and other interested stakeholders. It contains technical updates and revisions to legislation, together with guidance to insolvency practitioners. As a method for disseminating and implementing our proposals it has the advantage of reaching all insolvency practitioners and providing a coherent message.

7.66 We recommend that the Insolvency Service should produce an issue of Dear IP with guidance for insolvency practitioners as to the information they should provide.

7.67 Several other bodies issue guidance or directions to insolvency practitioners, including regulated professional bodies such as R3 and the ICAEW. We hope that the regulatory bodies will reinforce this guidance and monitor compliance with it.

Information from card issuers

7.68 Banks and building societies who issue credit and debit cards often give little prominence to chargeback. Many of their websites do not mention the possibility of chargeback for non-delivery of goods and services, or at least the information is very difficult to find. We proposed that card issuers should provide more information about chargeback.

7.69 This proposal was supported by all but one[25] of the consultees who answered this question. Several argued that card issuers were best placed to provide this information because of their relationship with the consumer. For example, Visa said:

> As the issuers have the direct contractual relationship with cardholders, it is only appropriate that the issuers detail such information under the terms and conditions of the card issued.

7.70 The Institute of Chartered Accountants Scotland concurred:

[24] The Joint Insolvency Committee (JIC) is made up of representatives from relevant professional bodies and from the Insolvency Service. It has responsibility for the revision of Statements of Insolvency Practice. More details can be found here. https://www.icas.com/technical-resources/joint-insolvency-committee

[25] 34 (97%) of the 35 respondents agreed that card issuers should provide more information about chargeback.

> We believe that card issuers have a responsibility to raise awareness of chargeback schemes and assist consumers with accessing these.

7.71 There was some discussion about when the information should be provided. Some respondents were concerned that information provided when the card was issued would be lost or buried in the small print. The Insolvency Lawyers' Association said:

> It will not be helpful to have such information buried in the minutiae of the terms and conditions sent to the consumer when the card is issued (which the consumer will then in all likelihood dispose of or lose).

7.72 Instead the information needs to be available when the consumer most needs it: at the time of the retailer insolvency.

Conclusion

7.73 We think that card issuers should provide clearer, and more accessible information about chargeback on their websites. The aim is that anyone who looks for material about "chargeback", "refunds" or "insolvency" on card issuers' websites or in their other published material should find a statement that a refund may be available, together with contact details of how to proceed. They should also provide a link to more detailed information: this should cover the time limits; the evidence which needs to be provided; and a statement that those who are dissatisfied with the response may complain to the Financial Ombudsman Service.

Method of dissemination

7.74 In the Consultation Paper we asked whether this information could be provided on a voluntary basis or whether it would require regulation.

7.75 We initially thought that the provision of information could be an issue suitable for regulation by the Financial Conduct Authority. However, FCA regulation does not cover all card issuers. We were told that the Payment Systems Regulator[26] would be the appropriate body to impose requirements on card issuers as its remit extends to the whole of the market. In any case, we now think that this is an issue best dealt with through voluntary guidance, which is more flexible and less likely to add to costs.

7.76 The UK Cards Association (UKCA) consider that they are the best placed to take forward this recommendation and ensure that card issuers make appropriate information available to consumers. They are the trade body for the card payments industry in the UK, representing financial institutions which act as card issuers and merchant acquirers. They are therefore able to provide guidance which can apply to the entire industry and set clear and consistent requirements.

[26] The Payment Systems Regulator is a subsidiary of the FCA but has its own statutory objectives, Managing Director and Board. It is responsible for the supervision and regulation of the payment systems industry, in particular eight designated payment systems including MasterCard and Visa.

7.77 We recommend that the UKCA prepare a code of best practice for card issuers concerning the provision of information about chargebacks and appropriate evidential requirements for raising a chargeback.

An authoritative guide about how chargeback works

7.78 Which?, Money Saving Expert and Citizens Advice provide helpful introductions to chargeback but, generally speaking, information on chargeback tends to be vague, unspecific or focussed on the voluntary nature of the scheme. We proposed that card schemes such as Visa and MasterCard should provide a publicly available authoritative guide.

7.79 The vast majority[27] of the respondents who answered this question were in favour of an authoritative guide. The general view was that such a guide would provide useful information to consumers but only if it could be done in clear, simple language. For example the Insolvency Lawyers' Association said:

> We agree that initiatives to make the chargeback process understandable to consumers are likely to be helpful. It is to be noted that the key is that consumers can understand the document. As such, brevity and plain language needs to be at the fore.

7.80 This was echoed by the Competition and Markets Authority:

> As consumers may struggle to understand complex financial matters, it will be important to ensure that guides are pitched at the right level to communicate effectively and straightforwardly, the information that consumers need.

7.81 At the time of publishing the Consultation Paper, MasterCard's scheme rules were available online[28] and, since publishing that paper, Visa Europe also made its "Operating Regulations" available online.[29] The problem is that, by their nature as contracts between two sophisticated commercial parties, the rules are not designed for consumers to read and digest. They are long (MasterCard's rules run to nearly 300 pages) and technically detailed. Most consumers would almost certainly find them impenetrable and difficult to grasp.

Conclusion

7.82 We recommend that a consumer guide to chargeback is produced, in the form of a standardised document to which all card issuers and card schemes can link.

7.83 It need not contain anything like the level of detail set out in the scheme rules. Instead it should be an accessible guide, focusing on the issues of greatest concern to consumers.

[27] 30 (91%) of the 33 who answered the question.

[28] https://www.mastercard.us/content/dam/mccom/en-us/documents/rules/mastercard-rules-june-2016.pdf.

[29] Visa's Operating Regulations have been retired and replaced. At the time of writing the new documents were not available online but could be requested from Visa: https://www.visaeurope.com/about-us/policy-and-regulation/veor.

7.84 This should include details of time limits. In particular, we think it would be helpful to include a table showing how they work in different scenarios. It should include a list of evidence which card issuers may require, with guidance about how to obtain it. Finally, it should tell consumers about their rights to complain to the Financial Ombudsman Service.

7.85 Again, we think the guide should use the term chargeback. We do not think that there is a simpler label which can be applied to the process which consumers will be able to grasp as quickly or easily as "chargeback".

Method of dissemination

7.86 We are pleased that the UKCA has agreed to take forward this recommendation. We think this will make life easier for insolvency practitioners and card issuers, who will simply be able to provide consumers with a link to, or copy of, this document.

Evidence of insolvency

7.87 We were told that staff training on handling chargeback claims differs between card issuers. Some provide more training than others with the result that consumers may have very different experiences if they contact their card issuer to ask about a refund. One particular inconsistency was the evidence which consumers are asked to provide to substantiate their claims. In some cases, inexperienced staff may ask for documents which are not available. Citizens Advice provided case histories in which staff suggested (wrongly) that consumers could obtain documentation about a retailer insolvency from Trading Standards.

7.88 In the Consultation Paper, we suggested that insolvency practitioners should make available on the insolvent retailer's website a confirmation that the company is in administration or liquidation. Consumers could then give this to their card issuer. Insolvency practitioners and other respondents to the Consultation Paper observed that the Insolvency Act 1986 already requires all company websites to state that the business is being managed by an administrator and to give the administrator's name. Some consultees thought that this was sufficient and that there would not be any merit in requiring an additional notice which duplicates information already on the website. Others, however, stated that this was often insufficient and card issuers could then rebuff consumers' requests for chargebacks to be raised on the basis of a lack of such evidence.

7.89 We think that the UK Cards Association is best placed to resolve this issue. If card issuers wish to have more than a simple link to a website, there may be a case for administrators to add a document to their websites, which consumers can download and send to their card issuers when requesting a chargeback.

7.90 We recommend that representatives of card issuers and insolvency practitioners should agree on the form and content of such a document to ensure that it is both:

(1) Sufficient to satisfy the evidential requirements of a successful chargeback; and

(2) Limited to high level information which it is reasonable for the insolvency practitioner to provide, and which they are not restricted or prevented from disclosing.

7.91 Both groups have indicated an intention to seek agreement on these issues.

7.92 In certain circumstances the card issuer may need to ask the consumer for further information which is specific to the particular case, but this should be easily identifiable and reasonably easy for a consumer to obtain.

OTHER FORMS OF PAYMENT

7.93 The use of debit and credit cards is forecast to continue to grow[30] and it can therefore be anticipated that chargeback will become increasingly important. However, new methods of payment are emerging which do not include chargeback protection.

7.94 The Second Payment Services Directive[31] encourages the emergence of new payment methods. It requires banks to be more open and aims to stimulate greater competition in the payment services sector. Whilst this promotes consumer choice and may reduce costs, the new methods do not necessarily offer the same protection as cards.

7.95 Below we look first at those new methods which do include some form of protection against retailer insolvency. We then discuss account-to-account payments which do not include protection.

New methods which protect against insolvency

PayPal

7.96 PayPal is an online payments system: purchases may be made either by transferring funds to a PayPal account which they can use to fund later payments, or by using a credit or debit card to fund the purchase using PayPal as a payment intermediary. Where a consumer simply makes a purchase using their card through PayPal it will also be protected by chargeback.

7.97 Consumers who pay for goods using funds in their PayPal account are protected by PayPal Buyer Protection.[32] This operates much like chargeback. If an order does not arrive, or significantly differs from its description, PayPal may reimburse the purchaser with the full cost of purchase and paid delivery costs. Purchasers must open a dispute within 180 days of the date of payment[33] and then must escalate the dispute to a claim within 20 days of opening it.[34]

[30] UK Cards Association, *UK Card Payments 2015*, pp 46 to 48.

[31] Directive (EU) 2015/2366 on payment services in the internal market. Available here.

[32] The protection does not extend to purchases of certain types of goods and services; see the User Agreement for PayPal Services (updated 6 January 2016) rule 13.4(a).

[33] Rule 13.5 (b).

[34] Rule 13.5 (c).

Smartphone apps

7.98 It is currently possible to make purchases on mobile devices via certain apps and this is again anticipated to be an area of significant growth. However, such payments are still typically made using a debit or credit card. Apple Pay, for example, facilitates card payments through iPhones and Apple Watches but the payments are still made using the credit or debit card linked to the Apple account. It is still possible therefore to raise a chargeback.

7.99 In addition, some retailers have developed bespoke apps which allow consumers to pay for goods or services with their smartphone.[35] Again, the typical model is that these apps require the consumer to input their credit or debit card details and therefore it appears that chargeback would still be available.

Account-to-account payments without insolvency protection

7.100 Some new payment methods do not include insolvency protection. Direct bank transfers between accounts, already possible through online banking facilities, are being made easier by services such as "Paym", which only requires the sender to know the recipient's mobile phone number. It is primarily targeted at transfers between friends and family and is unlikely to be used by a consumer to make a prepayment to a business.

7.101 However, similar technology is emerging for commercial use. Zapp's Pay by Bank app, for example, is linked to a consumer's bank account and facilitates the direct payment from the consumer's account to that of the business. As there is no card involved in the payment, there is no possibility that the purchase can be protected by chargeback. Whilst Zapp is not currently supported by all banks and building societies, several major high street banks do support it, including Barclays, HSBC, Metro Bank, Nationwide and Santander.

7.102 Barclays Pingit is a similar system but is limited to Barclays' customers. Other examples exist which are not exclusive to mobile devices. Sofort is targeted at online shopping but using the same premise of facilitating direct account-to-account payments which do not involve the use of a card.

Conclusion

7.103 We appreciate the benefits of account-to-account payments. They are marketed as being easy, fast and secure methods of payment and they avoid any card transaction fees. They will appeal to retailers as a lower cost option.

7.104 However, these payment methods may also appeal because they allow the retailer to receive funds more quickly. Unlike with cards, there is no merchant acquirer to hold back collateral, as currently happens with high-risk businesses. However, this swifter flow of payment to retailers can only be achieved by sacrificing the protections currently afforded to consumers by the card cycle. Unfortunately, it is possible that such options might be particularly attractive to the riskiest businesses, against which consumers are most likely to need protection.

[35] For example, Uber and the restaurant Busaba Eathai.

7.105 As new payment methods continue to emerge and develop, there is likely to be an increasing volume of consumer prepayments which are not covered by chargeback or afforded any other protection. In Chapter 8 we make the case for a limited preference on insolvency for consumers who cannot make use of the chargeback system because they have paid by cash, cheque or another payment method which does not give access to the chargeback scheme.

RECOMMENDATIONS

7.106 We do not think the proposals we have put forward require legislative change. Instead we have worked with industry bodies and representatives to provide guidance on conduct and to ensure that further information is provided on chargeback. This information is to be provided by various different organisations and it is therefore important that they co-operate to provide consumers with clear, coherent and consistent information.

Recommendation 3a: The Insolvency Service should produce an issue of Dear IP to give insolvency practitioners best practice guidance on:

(1) Advising consumer creditors who have paid by card to contact their card issuer to raise a chargeback.

(2) Advising consumers that further information on chargeback can be found in the UK Cards Association guide to chargeback.

(3) Providing on the retailer's website a confirmation that the company is in administration or liquidation, in a form which consumers can provide to their card issuer as evidence of the same.

(4) Making available to consumers other evidence or information which a card issuer may reasonably require.

Recommendation 3b: Insolvency practitioners and card issuers (through the appropriate representative bodies) should agree the form and content of a document which the insolvency practitioner will put on the website of an insolvency retailer and which the card issuer will accept from the consumer as evidence of the insolvency.

Recommendation 3c: The UK Cards Association should prepare a code of best practice for card issuers concerning the provision of information to consumers about chargebacks and the evidential requirements for raising a chargeback.

Recommendation 3d: The UK Cards Association should prepare a chargeback guide for consumers. It should include greater information on time limits and complaints. Card issuers and card schemes should link to this document, which should be kept up to date.

CHAPTER 8
CONSUMERS' STATUS IN THE INSOLVENCY HIERARCHY

8.1 In Chapter 2, we outlined several ways in which consumers may be protected on insolvency. Consumers may seek refunds from their card issuer, or administrators or purchasers of the failed business may decide to honour prepayments. In some cases, the business may have acted to safeguard consumer prepayments before becoming insolvent.

8.2 In the absence of these protections, consumers are left with a claim under insolvency law to receive a share of whatever assets the business still owns. Insolvency law requires claims to be paid according to a strict hierarchy, with employees and secured lenders towards the top of the list and consumers towards the bottom. Consumers are unsecured creditors, taking a share of any remaining assets alongside many others, including suppliers, landlords and tax authorities.

8.3 The amount of money distributed to unsecured creditors tends to be small, and is often negligible. In our survey of high street insolvencies, the payments to consumers were generally less than 1% of their claims. One question which this project seeks to address is whether the law should be changed to give consumers a more favourable status on insolvency.

THIS CHAPTER

8.4 Here we start by describing the current hierarchy of creditors. These rules are set out in statute and reflect difficult political decisions about how to allocate losses between equally innocent parties.

8.5 In the Consultation Paper we provisionally proposed giving preferential status to a limited category of claims by consumers who had paid a significant amount in the run up to insolvency and who were not protected by other means. This was and remains controversial. We discuss the arguments for and against such a change.

8.6 Ultimately, whether to provide greater protection for consumers is a political decision for Government. However, if the decision is taken to provide greater protection to consumers, one way to do this would be to change the statutory hierarchy. This would give enhanced rights to qualifying consumers across all sectors and classes of business, to meet new or unforeseeable risks.

8.7 We outline a limited proposed change, designed to cause the least disruption to business lending and the process of liquidation. The scheme would require a restricted category of large consumer claims to be paid in priority to payments to floating charge holders (usually banks or other financiers).

THE CURRENT STATUTORY HIERARCHY OF CREDITORS

8.8 If a business cannot be rescued as a going concern, the administrator or liquidator will seek to realise as much money as possible from the company's remaining assets, either by selling the business or parts of it, or by selling individual assets.

8.9 Once the business has been liquidated, its money must be distributed to creditors in the following order:[1]

(1) Fixed charge holders (up to the value of realisation of assets subject to the charge);

(2) Expenses of the administration or liquidation;

(3) Preferential creditors;

(4) Floating charge holders (less the prescribed part);[2]

(5) Unsecured creditors; and

(6) Shareholders and members.

8.10 We explain each rung of this hierarchy below. More detail is available in our Consultation Paper.[3]

8.11 The payment to fixed charge holders is limited to the value realised from their security (typically the sale proceeds). For everyone else on the list, each category must be paid in full before any distribution is made to the next category. In many recent high street retailer insolvencies, while the preferential creditors received full payment, the remaining assets were exhausted during distribution to the floating charge holders, leaving nearly nothing for unsecured creditors.[4]

Fixed charge holders

8.12 Fixed charge holders are secured lenders (typically banks or investment funds) who have registered a charge with Companies House over specific assets such as land, machinery or intellectual property.

8.13 After deducting the costs of realisation, the insolvency practitioner must use the proceeds of sale of the relevant assets to satisfy the fixed charge holder's claim. These proceeds are not available to other creditors unless there is a surplus after the fixed charge holder has been paid in full.

[1] See *McPherson's Law of Company Liquidation* (3rd ed 2013), para 13-027.

[2] The prescribed part is explained at para 8.24.

[3] See Consultation Paper, Ch 2.

[4] See Consultation Paper, Ch 3 and below from para 8.26.

8.14 Frequently, the amount realised through sale of the asset(s) will not suffice to satisfy the fixed charge holder's claim completely. In this case, the outstanding amount owed to the fixed charge holder will be an unsecured claim – unless the fixed charge holder also has a floating charge. Typically, banks and other financiers hold a mix of fixed and floating charges. They are referred to as "secured creditors".

Expenses of the administration

8.15 The expenses of the administration or liquidation cannot be discharged from assets subject to a fixed charge, but they are paid in priority to all other claims.[5] They include not just the administrator's or liquidator's fees but also other expenses which arise during a period of trading in administration (including rent on occupied premises, VAT, staff pay and utility bills).[6]

8.16 The effect is that debts incurred before an insolvency are treated differently from debts incurred during a period of trading in administration: for example, VAT on goods sold before insolvency gives rise to a mere unsecured claim for HMRC, while VAT on goods sold during administration is an expense of the administration. As we discussed in the Consultation Paper, this distinction is far from straightforward and has been the subject of recent litigation.[7]

Preferential creditors

8.17 Next the claims of preferential creditors are paid in priority to all other debts.[8] For our purposes,[9] the only debts given preferential status are those owed to employees and employee schemes.

8.18 In law, the position of employees on insolvency is rather complicated, as they may receive payment in four separate ways:

(1) *As an expense of the administration*: employees who continue to work during the administration are paid their ongoing wages.

[5] Insolvency Act 1986, s 176ZA (liquidation); para 99(3)(b) of sch B (administration).

[6] Insolvency Rules 1986, rule 2.67(1)(a). Permissible expenses, and their relative order, are set out in rule 2.67.

[7] See Consultation Paper, paras 2.34 to 2.38. In *Jervis v Pillar Denton; re Game Station* [2014] EWCA Civ 180 the Court of Appeal confirmed that administrators must pay rent for the period they remain in occupation of the premises for the purposes of trading, irrespective of whether the rent falls due before or after the company enters into administration.

[8] Insolvency Act 1986, ss 175 and 328 (liquidation); para 65 of sch B (administration).

[9] Preferential status is also given to levies on coal and steel production and deposits covered by the Financial Services Compensation Scheme but these are not relevant to retailer insolvency.

(2) *As preferred creditors*: the list of preferred debts is set out in schedule 6 of the Insolvency Act 1986 and covers contributions to eligible occupational pension schemes, holiday pay, and some arrears of wages. The wages must have been owed in the four months prior to the insolvency and are limited to £800 in total.[10]

(3) *Through a government guarantee*: the money comes from the National Insurance Fund and is administered by the Redundancy Payments Service (RPS). These arrangements cover statutory redundancy and certain other contractual payments.[11] The payments are subject to a weekly cap - currently £475 per week.[12]

(4) *As unsecured creditors*: employees may sometimes be owed money in addition to these categories, such as contractual redundancy pay for a greater amount than the statutory minimum.

8.19 In practice, the RPS will often pay the employees and then seek to recoup payments against the company as a preferential claim.[13] There is an overlap between an employee's preferential claim and their claim against the RPS, but the two sets of liabilities are not identical. The Government has a preferential claim against the company for money paid to employees which falls within schedule 6 of the Insolvency Act 1986. If the Government has paid other claims, such as statutory redundancy, these are unsecured debts.

8.20 Contributions to eligible pension schemes (generally defined benefit schemes) will have priority status.[14] Others rank as unsecured debts.

8.21 In the high street insolvencies we looked at, all expenses of the administration and all preferential claims were paid in full, with some money left over for floating charge holders. This means that employees received wages for working during the administration; all arrears of holiday pay; and most arrears of wages. They will also have received statutory redundancy pay from the RPS.

8.22 However, if employees had other claims (such as contractual redundancy), the distribution for these unsecured claims will have been the same as that paid to consumers.

[10] Insolvency Proceedings (Monetary Limits) Order 1986, art 4.

[11] Employment Rights Act 1996, Part XII. For more detail, see Consultation Paper, from para 2.39.

[12] Employment Rights (Increase of Limits) Order 2015, Art 3 and item 7 of the schedule to the Order. The amount paid by the Government may be more than the company's statutory liability under sch 6 to the 1986 Act, given the cap of £800 on wage arrears referred to above.

[13] The effect of s 189 and para 11 of sch 6 to the 1986 Act is that the Government has a preferential claim in respect of money paid to employees in order to meet the company's obligations under that schedule. If the Government has paid more than the company is obligated to pay, this is unsecured debt.

[14] Pension scheme contributions which fall within Schedule 4 of the Pensions Schemes Act 1993 have a priority. In terms of direct benefits to employees, the Pension Protection Fund (PFF) may pay compensation to members of eligible pension schemes (generally defined benefit schemes) where there are insufficient assets in a company's pension scheme to cover PPF levels of compensation. The PPF will then have an unsecured claim against the insolvent employer's estate.

Floating charge holders

8.23 Like fixed charges, floating charges must be registered at Companies House. However, a floating charge may apply to all of the company's assets, both present and future, including stock and bank accounts. In some cases there may be more than one floating charge holder: the second holder will be paid only after the first has been paid in full.[15]

8.24 Floating charge holders are in a powerful position. To mitigate this power, the Enterprise Act 2002 requires some money to be set aside for unsecured creditors before the floating charge holder is paid. This is known as "the prescribed part". It is subject to a statutory maximum which is currently £600,000.[16] The maximum applies whenever the net property available to floating charge holders exceeds £2.985 million.

8.25 In our sample of 20 high street insolvencies, 17 had floating charge holders. In all 17 instances, the charge holder received some payment, but the level of return varied. On average, the secured creditors in our sample received 30% to 40% of the claim, with the lowest return being 9%. In our sample of smaller insolvencies, there was one case where the floating charge holder received nothing at all.[17]

Unsecured creditors

8.26 The prescribed part, together with any remaining assets, is divided among the unsecured creditors, with each receiving the same proportion of their debt. Unsecured creditors are often numerous. As well as consumers, they may include contractors, suppliers, landlords, utility companies and HMRC. Unsecured claims can be substantial. In the 20 high street insolvencies we looked at, the value of unsecured claims varied between £11 million (Dwell) and £699 million (Woolworths).[18]

Substantial distributions to unsecured creditors

8.27 Where the retailer had no secured creditors, the unsecured creditors received a slightly more substantial amount. The unsecured creditors received the largest repayment in Zavvi (25.9 pence in the pound) but some returns were also forthcoming in Blockbuster (14 pence) and Land of Leather (7 to 9 pence).

8.28 Where there are floating charge holders, it is relatively rare for any money to be left over after the floating charge holders have been paid. In our sample, we found only one case (La Senza) where the secured creditors were paid in full with assets left over for unsecured creditors: at the time of writing, liquidators expect unsecured creditors to receive around 8 pence in the pound.[19]

[15] Similarly, where there are three floating charge holders, the third will only be paid after the second and so on.

[16] Insolvency Act 1986 (Prescribed Part) Order 2003 sets out the method of calculation, and the current cap. See Consultation Paper, from para 2.51, for more detail.

[17] See Consultation Paper, paras 3.21 to 3.26.

[18] The value of unsecured claims in the Woolworths case was high due to the presence of significant intra-group loans.

[19] Liquidator's progress report, 29 February 2016.

Distribution limited to the prescribed part

8.29 In most cases, the only money available for unsecured creditors is the prescribed part. A prescribed part of £600,000 was distributed among unsecured creditors in several insolvencies in our study, including Peacocks, Comet, HMV and Focus DIY.[20] However, with unsecured claims ranging from £120 million (Peacocks) to £650 million (Focus DIY), this resulted in distributions of less than one penny in the pound.

8.30 The costs of distributing the prescribed part tend to be high. In Peacocks, the costs associated with its distribution were £199,000, effectively reducing the prescribed part to £401,000 – to be shared between 18,653 different unsecured creditors.

8.31 The prescribed part can be disapplied by the administrators on application to the court.[21] This occurs where there are so many unsecured creditors that each creditor's share would be minimal and the administrative burden would be significant. In our sample, the prescribed part was disapplied in three cases, meaning that there was no return to unsecured creditors.

8.32 Even where the prescribed part is distributed, the sums are so small that they are unlikely to make a difference to any particular creditor. For example, in JJB Sports, the costs of distributing the prescribed part were £150,000, and resulted in a dividend of 0.34 pence in the pound, meaning that a consumer with a £100 claim would receive 34p.

8.33 The operation of the prescribed part is outside our terms of reference, but these figures raise questions about whether it is achieving its objective. Even increasing the prescribed part by 20 or 30 times – which would likely be untenable for floating charge holders – may not provide consumer creditors with any appreciable benefit. However, the prescribed part may be of more use in other insolvencies outside the retail sector which have fewer unsecured creditors.[22]

Shareholders and members

8.34 Any surplus – of which there is generally none – would be distributed to shareholders of the company.

A DIFFICULT BALANCE

8.35 The statutory hierarchy balances many competing interests. A political decision has been made to give employees preferential status because of the particularly vulnerable situation in which they find themselves following their employer's insolvency, especially if pension contributions, holiday pay and wages have not been paid. This justifies their elevated position in the hierarchy.

[20] The value of the prescribed part depends on the company's "net property", ie the assets available to floating charge holders. It will not always reach the statutory cap of £600,000: in Habitat, the prescribed part was £165,000 and in Jessops, £197,000.

[21] Insolvency Act 1986, s 176A(5).

[22] The Insolvency Service undertook a review of the prescribed part in 2008 but concluded that it was then still too early to judge its impact or assess whether its amount had been set at an appropriate level. The Insolvency Service, *Enterprise Act 2002 - Corporate Insolvency Provisions: Evaluation Report* (January 2008) pp 136 to 143. Available here.

8.36 Meanwhile, secured creditors have taken steps to protect themselves in the event of insolvency by taking a security specifically to put themselves ahead of other creditors. The granting and taking of security plays a crucial role in ensuring that credit is available to businesses who seek it, either at all or on favourable terms.

8.37 The very nature of insolvency means that there is not enough money to repay all creditors. Any change to the hierarchy to promote one group would necessarily have an impact on those further down the list. In 1982, the Cork Committee was wary of all forms of differentiation among unsecured creditors. It pointed out that some trade creditors may suffer more serious consequences than consumers. As relative hardship was impossible to ascertain, its starting point was that all unsecured creditors should be treated equally.

8.38 On the other hand, the Office of Fair Trading (OFT) and Consumer Focus have argued that consumers should be given preferential status.[23] The main argument is that consumers do not possess the same information or commercial awareness as other unsecured creditors and do not understand the risk they are taking. Thus money taken from unsuspecting consumers should not be used to repay a company's other debts or fund its business model.

8.39 Other common law jurisdictions have also grappled with these issues:

(1) In the United States consumers are granted a priority over other unsecured creditors, where claims arise from the deposit of money for goods or services which were not delivered or provided.[24]

(2) In New Zealand, there is a statutory priority for "layby" sales, where goods are paid for by instalments and only delivered when payment has been made in full. In 1999 the New Zealand Law Commission considered the justification for this priority and concluded that it should be retained.[25]

(3) In Australia, an argument has been made for a new consumer priority,[26] which has become more pressing since the electronics retailer Dick Smith entered insolvency in January 2016.[27]

8.40 The issue clearly involves difficult value judgements.

[23] Director General of Fair Trading, *The Protection of Consumer Prepayments* (March 1986); Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006); S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009).

[24] 11 US Code § 507(a)(7). It is subject to a maximum amount, adjusted to $2,775 on 1 April 2013.

[25] Layby Sales Act 1971, s 11(1). In 1999 the New Zealand Law Commission considered the justification for this priority and concluded that it should be retained: *Priority debts in the distribution of insolvent estates: an advisory report to the Ministry of Commerce* (October 1999) pp 46 and 47.

[26] For further discussion see C Symes, *Statutory Priorities in Corporate Insolvency Law* (2008) Ch 8.

[27] This is discussed below at para 8.69.

CONSULTATION PROPOSALS

8.41 In the Consultation Paper we argued that not all consumer claims should be given preferential status. Many are for small values where not much hardship has been suffered and would be expensive to process and distribute. Some types of debt, such as damages for faulty goods, are particularly difficult to assess. In addition, most sales are now paid for by credit or debit card,[28] so a section 75 or chargeback remedy is likely to be available.

8.42 To provide a special status for all consumer debts could substantially reduce payments to secured lenders, thereby making lending more risky and, in consequence, more expensive. We also agree with insolvency practitioners that it would add unnecessary cost and delay if liquidators were required to pay large numbers of small or uncertain claims before providing any payment to floating charge holders.

8.43 However, we proposed a limited reform which targets the most serious cases: that is, where retailers have taken large sums by cash or some other unprotected method of payment shortly before becoming insolvent. Over the last 16 years there have been some high profile losses where retailers have taken payments of this kind. Our study has highlighted four particular cases, shown in Table 4, of which Farepak involved the greatest potential for loss.

Table 4: Examples of consumer prepayments not protected by chargeback

Company	Year	Estimated prepayments not protected by chargeback
World of Leather	2000	£2.4 million
Farepak	2006	£37.0 million
MFI	2008	£8.5 million
Homeform	2011	£1.5 million

8.44 As it is not possible to foresee where the next collapse with consequences akin to Farepak might arise, we wished to see some protection of last resort which would apply across all business sectors.

8.45 In these four cases most unprotected payments were made by cash or cheque. Although cash or cheque payments are now less common, new payment methods are emerging. As we discussed in Chapter 7,[29] the developing account-to-account payment systems (unlike credit and debit cards) do not retain collateral or provide consumers with protection against non-delivery. They might therefore be particularly attractive to less stable businesses.

[28] In March 2016, card sales amounted to 77.4% of all retail sales: see UK Cards Association, *Card Expenditure Statistics March 2016*, p 6. Available here.

[29] From para 7.93.

8.46 We proposed that a consumer should have preferential status if their claim met *all* of the following criteria:

(1) The *claimant is a consumer* as defined in the Consumer Rights Act 2015.

(2) The claim relates to a *prepayment*. In other words, the consumer has paid money to the insolvent business (or has parted with goods with a money value), and did not receive goods or services in exchange at the time.

(3) The payment is made *during the months* leading up to insolvency, when the financial problems facing the company are likely to have become apparent. We asked if preferential status should apply only to prepayments made in the three months before insolvency.

(4) The *claim is sufficiently large* to justify the costs of distribution. We asked if preferential status should be limited to claims where the consumer has paid £100 or more, either in a single transaction or in a series of linked transactions.

(5) The consumer *is not protected by other means*. For example, it would not cover payments by credit and debit cards where a section 75 or chargeback remedy is available, where insurance is available to cover the loss, or where the money has been held in trust and can be returned to the consumer.

8.47 The preference would rank below preferential claims from employees, but above floating charge holders.

CONSULTEES' VIEWS

8.48 Any change to insolvency priority is controversial. This was highlighted by the response. Only one third of the consultees who responded to this proposal were explicitly in favour of a limited preference for some consumers.[30] Insolvency practitioners had the strongest objections.

8.49 Below we start by making the arguments for enhancing consumers' status on insolvency. We then look at the contrary arguments, before reaching a conclusion.

THE ARGUMENTS FOR ENHANCING CONSUMERS' STATUS

8.50 In our Consultation Paper, we set out three possible arguments for increasing the status of consumer claims:

(1) Consumers are often vulnerable and may suffer hardship;

(2) When making prepayments consumers are effectively lending money to the business, but unlike other creditors they do so without being in a position to assess the credit risk; and

[30] 10 agreed in principle, 16 objected and 5 marked "other".

(3) The current statutory hierarchy sets up a perverse incentive. Where a business tries to trade its way out of difficulty by taking more prepayments, secured lenders have little incentive to prevent this, as payments from consumers will increase the return to floating charge holders.

Hardship

8.51 As we saw in Chapter 2, the bulk of consumer losses are borne by those who pay by cash or cheque, and who are not protected through section 75 and chargeback. As Consumer Focus pointed out, these buyers are particularly likely to be financially vulnerable.[31]

8.52 A report from Citizens Advice provided examples of hardship.[32] These included an elderly man who paid £6,000 for a bathroom by cheque; a low income family who paid £981 for a sofa and arm chair; and a family with a disabled child left without the freezer they had paid for.

8.53 However, we do not think that hardship alone is a sufficient reason to consider introducing preferential status for these claims. Many trade creditors may also be vulnerable (such as unpaid contract cleaners, self-employed van drivers, or local suppliers). These self-employed contractors and small businesses may lose large sums and sources of income on which they depend. They would have an equal case or better case for preferential status, if that was to be awarded on the basis of hardship alone. This was the reason the Cork Report did not favour a distinction between different unsecured creditors.

Inability to assess risk

8.54 Prepayments differ from other consumer claims because the prepaying consumer has given new money to the business. Effectively, the consumer makes a loan to the business, but is not able to assess the risks of that loan.

8.55 The analysis provided by Citizens Advice emphasised that in many cases the company went into administration shortly after the order was placed. In some cases this was a few days – and at its extreme, only a few hours:

> My grandmother purchased a cooker from [trader] last week, the following day they announced they were going into administration.
>
> Client['s] … sister had bought a new kitchen for £5,000... [Trader] called back and asked for the balance of £3,200 and then went into liquidation later that day.

8.56 For the consumers concerned, it appeared that the company was deliberately getting in as much money as possible, knowing that there was a substantial chance that the goods or services would never be supplied. The consumers provided the money in ignorance of the risks.

[31] Steve Brooker for Consumer Focus, *Pay now, pay later: consumer prepayments and how to protect them* (August 2009) pp 11 and 16.

[32] The examples were taken from telephone calls to the Consumer Service and from Bureau Evidence Forms.

8.57 While consumers generally cannot assess insolvency risk themselves, those who pay by credit and debit card benefit from the fact that merchant acquirers assess the risk on their behalf. In discussion, merchant acquirers emphasised that they monitor insolvency risks closely, looking for any unusual patterns or payments. They can respond to these risks by taking collateral to refund consumer prepayments through chargeback. Effectively, they act as proxies for consumers, assessing and responding to insolvency risks, in a way which consumers are not able to do individually.

8.58 Trade creditors also have some mechanisms to protect themselves, such as retention of title clauses, credit insurance or changed payment terms.

8.59 On the other hand, cash-paying consumers are unable to assess the insolvency risk or take alternative action, and there is no one to take this action on their behalf. There is nobody holding back collateral to refund their claims if necessary. This means that, at present, whether a consumer is shielded from loss depends almost entirely on their payment method.

Perverse incentives

8.60 It might be argued that a company which its directors know to be in financial difficulty should cease to take consumer prepayments – or at least protect them in a trust account - given that there is a chance that the prepayments will not be honoured. This certainly seems like good practice. However, cutting off this income stream may ultimately be the tipping point which forces the company into insolvency. In a genuine effort to save the company, directors might in fact feel that by *increasing* the prepayments it takes, the company's cash flow will be boosted and insolvency may be avoided.

8.61 In addition, struggling businesses may find that their merchant acquirers hold back large amounts of collateral, so may persuade consumers to pay by cash or cheque instead of card. For example, the elderly man referred to above who paid £6,000 for his bathroom was persuaded to pay "by cheque not credit card which was his first choice".

8.62 Trading standards officers referred to these practices more colloquially as "busting out": that is, the desperate search by a business on the verge of insolvency for new money, often from consumers who are ignorant of the problems.

8.63 We discuss directors' potential liability for such behaviour elsewhere.[33] However, whatever the directors' motivation and ultimate liability, the effect of these practices demands closer scrutiny. If the business is not saved and becomes insolvent, the current rules effectively mean that the direct beneficiaries of these additional payments taken from consumers will be the floating charge holders. The Farepak case provides a stark example.

[33] See discussion from para 4.31, and Apx B.

"Busting out" in Farepak?

8.64 In Farepak, when an action for disqualification against the directors was discontinued, the judge took the unusual step of issuing a statement in open court to comment on the case. While Mr Justice Peter Smith felt that the directors had made "genuine strenuous efforts" to save the company, he took the opportunity to criticise Farepak's bank, HBOS, which he said had "a policy of playing hardball".[34]

8.65 The directors had asked HBOS on at least two occasions whether Farepak could protect future deposits (by holding them on trust) or stop taking deposits altogether. Both these proposals were refused by the bank, meaning the directors "were in effect obliged to continue to receive the deposits and pay them over for the bank". The judge said that HBOS had "substantially benefited" from deposits that were received in the two months preceding the group entering administration; indeed, it was perhaps the "sole beneficiary" of the consumers' payments. The judge found that HBOS was aware that deposits accepted during these last two months were "overwhelmingly likely" to be lost. In the end, HBOS received full recovery of the indebtedness owed to it, £10 million of which was attributed to the continued taking of deposits.

8.66 The judge noted that HBOS had acted lawfully: it was perfectly entitled to enforce its security. However, both he and (subsequently) the Secretary of State urged HBOS to make a further contribution to the distress fund for Farepak customers beyond the £2 million it had already pledged. Lloyds Banking Group, which acquired HBOS in 2009, contributed an additional £8 million. It also met its own legal fees, allowing a further £1 million to be distributed to the unsecured creditors.

Removing the perverse incentives

8.67 The Farepak case may represent an extreme example, both because of the bank's explicit refusal to allow any consumer protection and because of the particular vulnerability of the affected consumers. However, even in less controversial cases, continuing to take prepayments during a period of severe financial instability is likely to produce a direct benefit to floating charge holders and a direct loss to consumers.

8.68 There is a strong case for removing the perverse incentives on floating charge holders to encourage (or at least tolerate) failing businesses to seek additional cash payments from consumers at a time when those "in the know" realise that contracts may not be fulfilled. Giving preferential status to large cash prepayments made in the months leading up to insolvency would encourage banks to monitor how far the business is relying on such payments. It would remove any incentive on secured lenders to allow an increase in such deposits, as floating charge holders would no longer benefit from them. In their consultation response, the Competition and Markets Authority agreed, saying:

[34] Farepak judge's statement (June 2012), para 4. Available here.

> We agree that it would have the benefit of eliminating any potential 'perverse incentive' on floating charge holders to encourage accumulation of prepayments. It would similarly help to eliminate any potential 'perverse incentive' around the timing of insolvency of businesses that are subject to seasonal factors that might cause consumer prepayments to accumulate at a particular time of year (e.g. in the run up to Christmas or other holidays).

8.69 The perception that retailers and their lenders behave in this way is an ongoing issue, and not just in the UK. The winding up of Australian electronics retailer Dick Smith in early January 2016 has been heavily criticised, with suggestions that the company's lead creditors intentionally let the struggling retailer trade through Christmas in order to wait for the "max cash point" at which to pull the plug.[35] In addition, the retailer offered its gift vouchers with an additional 10% bonus throughout December 2015, encouraging additional purchases of vouchers which, at the time of writing, it does not seem will be honoured. Speculation about the company's solvency had already been publicised in the weeks before Christmas.[36]

THE CONTRARY ARGUMENTS

8.70 All 12 insolvency practitioners who responded to our Consultation Paper argued against any change to consumers' status in the insolvency hierarchy. They put forward four main arguments against change:

(1) It would undermine the position of creditors who have tried to protect themselves by taking floating charges, and lead to an increase in the cost of borrowing.

(2) In some cases, raising the status of consumers would mean less money for other unsecured creditors, such as self-employed contractors and small businesses.

(3) Any change could add complexity, delays and costs to the process of liquidation.

(4) Providing a preference to only a limited number of consumer claims could lead to arbitrary results. Consumers would have no guarantee of protection and might be confused and unsure as to whether their prepayment was protected.

Impact on floating charge holders

8.71 Our proposal would not affect fixed charge holders, expenses of the administration, or employees; these claims would continue to be paid ahead of consumer claims.

[35] See, for example, *NBR*, 'Five serious questions about Dick Smith collapse' (6 January 2016). Available here.

[36] See, for example, *Sydney Morning Herald*, 'Dick Smith back away from profit guidance after inventory write-off' (30 November 2015). Available here.

8.72 However, it would affect floating charge holders, who would only be paid once the preferred consumer claims had been met. Insolvency practitioners argued that the change would increase the cost of borrowing, while Correlation Risk Partners said that banks might be less inclined to lend as a result. Affordable borrowing is a lynch pin of the UK business market. Consultees were concerned that giving more protection to consumers at the expense of lenders would hinder that market.

Response

8.73 We do not think the impact would be as great as some consultees feared. At present, most consumer prepayments are made by debit and credit card.[37] Here merchant acquirers act as proxies for consumers by assessing insolvency risk on their behalf. They hold back money which is not available for distribution to floating charge holders until consumers have been paid. Floating charge holders have accepted this system and the significant increase in card payments has not led to the collapse of lending to retailers.

8.74 The aim of the proposal is to bring the small minority of businesses receiving large payments in cash and other unprotected ways into line with what already happens in the great majority of retailer insolvencies, where payment has been made by card.[38]

8.75 We accept that it might make floating charge holders more cautious in lending to those few businesses which take large cash deposits or which switch to new payment methods where no collateral is held back. We think this caution would be an advantage, as lenders would focus on the underlying strength of the business rather than securing their lending on consumer deposits.

Monitoring businesses' reliance on cash deposits

8.76 In the Consultation Paper, we asked whether floating charge holders were able to monitor how far a businesses relied on cash payments, or encouraged them in the run up to insolvency (as occurred in the Dick Smith case). Insolvency practitioners thought that floating charge holders rarely had control over these sorts of decisions. R3's Scottish Technical Committee said:

> The whole concept of a floating charge is not designed to give control, and introducing the need for charge holders to monitor such funds may alter the nature of the charge and introduce the risk of shadow directorship to any bank seeking to intervene in a customer's commercial activities.

8.77 We agree that floating charge holders should not be required to actively monitor the payments. However, the limited preference would remove the current incentive to encourage the business to take in more prepayments in the run up to insolvency.

[37] UK Cards Association, *Card Expenditure Statistics March 2016*, p 6. Available here. For larger payments, a much higher proportion is made by card.

[38] The effect of the proposal would be also similar to holding the money on trust (which already occurs and is accepted as good business practice).

Impact on other unsecured creditors

8.78 The proposal would have less of an impact on unsecured creditors. In 16 out of the 20 high street insolvencies (and 7 out of 11 smaller retailer insolvencies) there was no return to unsecured creditors, outside the prescribed part. In such cases, the effect of the proposal on unsecured creditors would be negligible:

(1) For larger insolvencies, where at least £2.985 million would continue to be available to floating charge holders, there would be no effect: the prescribed part would continue to be £600,000.

(2) Where less money is available, a return to consumers may reduce the size of the prescribed part. However, the sums available to unsecured creditors from the prescribed part tend to be so small that the effect on any particular claimant would be insignificant.

8.79 Where there are no floating charge holders, unsecured creditors receive non-negligible sums: in our sample, these ranged from 7p to 26p in the pound. Consultees pointed out that in these cases unsecured creditors (such as self-employed contractors and small businesses) would receive less money, and may be equally or more deserving of protection. The Institute of Chartered Accountants of Scotland (ICAS) pointed out that the proposal would give consumers "a higher ranking than involuntary creditors which would seem a strange situation".

Response

8.80 The main reason for giving a preference to this category of consumer over other unsecured creditors is that they provide the business with new money without any ability to assess or manage the risks and with no "proxy" such as a merchant acquirer to do that on their behalf.

8.81 We think that any negative impact on other unsecured creditors would be small, but may occur in some circumstances. As we conclude below, whether consumers should sometimes be protected at the expense of other unsecured creditors is a political decision, best made by elected representatives.

Additional complexity, costs and delay

Insolvency practitioners argued that paying some consumer claims at an earlier stage would add to complexity, delays and costs. The Institute of Chartered Accountants of England and Wales (ICAEW) said it would add "a great deal of complexity" leading to "uncertain results". R3 said an additional category of preferential creditor would "add both delay and cost because of the need to scrutinise a large number of small claims".

Response

8.82 Except in the minority of cases where the prescribed part is disapplied, insolvency practitioners already assess consumer claims. The main change is that liquidators would have to carry out this assessment at an earlier stage – before a payment is made to floating charge holders.

8.83 We accept that assessing many small claims at an early stage could introduce delays into the process of liquidation. Small claims can take time and money to consider, often out of proportion to their value.

8.84 However, we think these concerns can be mitigated. As discussed below, we have raised our suggested minimum claim from the £100 which we suggested in the Consultation Paper to £250.

Arbitrary results

8.85 Some consultees argued that giving preferential status only to certain claims could be confusing and arbitrary.

8.86 Citizens Advice were concerned at the suggestion that preferential status should be limited to prepayments made within the last three months. It saw

> no compelling reason that consumers who paid for their goods more than three months in advance should be denied the same level of protection.

8.87 ABTA thought that it would be unfair to treat consumers who had dealt with a trader at an earlier time differently to more recent customers, and Moore Stephens felt an arbitrary cut-off could anger some consumers. R3 and other insolvency practitioners thought that a threshold would increase the complexity of administration and encourage abuse.

8.88 ABTA also criticised the minimum amount:

> There could be some unfortunate and unfair consequences to such an approach. A prepayment of £101 could be returned in full, but a deposit of £99 might be lost in its entirety.

8.89 Some consultees pointed out (correctly) that preferential status is no guarantee of recovery. Without sufficient funds available, even preferential creditors may not be paid.

Response

8.90 The limited preference is not designed to protect consumers in all circumstances. It would cover only the most serious cases, where firms take new (and substantial) cash payments from consumers in the run-up to insolvency.

8.91 Although consumers who miss out would be frustrated, they would not be in a significantly worse position than they are under the current rules, where they are unlikely to receive any but the most negligible refund.

REFINING THE PROPOSED SCHEME

8.92 Following consultation, we have rethought some aspects of the scheme. As we discuss below, we now think that preferential status should be given only to payments of £250 or more (rather than £100); however, it should apply to money paid within the last six months, rather than only three months.

The minimum amount

8.93 In the Consultation Paper we proposed that any preferential status should be limited to claims where the consumer has paid £100 or more, either in a single transaction or in a series of linked transactions (for example, an initial deposit and subsequent instalments). 25 consultees responded to this proposal, and opinions were divided.[39]

8.94 Most consultees recognised that the administrative costs of refunding a large number of small claims would be disproportionate: therefore a minimum amount was justified. But several insolvency practitioners thought that the limit was too low. KPMG said that prepayments are often for amounts far in excess of £100, for example in respect of furniture, motor vehicles and holidays. Such a low limit would offer floating charge holders very little protection:

> This will therefore provide no real limit to protect the floating charge holders and will also create a significant level of additional work and additional associated time costs to agree and pay these claims in an insolvency.

8.95 Given the concerns expressed, particularly by insolvency practitioners, about the difficulty and cost of administering small claims, we are persuaded that any limited preference should only apply to consumers who have made larger prepayments – we suggest £250 and over.

Limiting preferential status to payments in the run up to insolvency

8.96 In the Consultation Paper we asked if the preferential status should apply to money paid within a set period before the insolvency. We suggested a possible period of three months.

8.97 We received 28 responses to this question. Responses were relatively evenly split between those in favour of a time limit and those against.[40]

Arguments for a three month time limit

8.98 Citizens Advice highlighted that many consumers are persuaded to part with cash and cheques shortly before insolvency. Although they argued against a time limit, in previous discussions they thought that a preference would have a beneficial effect even if it was confined to a limited period before the retailer enters administration.

8.99 The Chartered Trading Standards Institute also supported a three month limit on the grounds that it was

> the likely time scale in which directors might seek a remedy to financial difficulty and the time when insolvency legislation might apply.

[39] 10 consultees (40%) were in favour of a limit to potential claims, eight (32%) were against a limit and seven (28%) marked “other”.

[40] Nine consultees (32%) were in favour of a time-limit and seven (25%) marked “other”. 12 (43%) were against it.

8.100 ICAS opposed a new preference but added:

> Should preferential status be pursued then we would agree that a set period would be an appropriate way of assessing the 'cut-off'. This is consistent with other areas of legislation (for example unfair preferences).

Arguments against a three month limit

8.101 Other consultees suggested that that a three month time frame might prejudice those who had parted with their money at an earlier date. For example, ABTA said:

> We are simply not convinced that that it is fair or equitable to prefer later consumers to those whose funds have been on deposit for longer with the trader.

8.102 The Farepak Victims Committee stressed that Christmas savings schemes, running on a 10 to 12 month basis, would take large prepayments over a long period and it would be unfair not to protect these.

8.103 Professor Sheehan thought that the time-limit should be six months, to align it with insolvency legislation on preferences. He argued that the rationale behind the six month time limit under section 239 of the Insolvency Act 1986 was that the business has at that time the opportunity to assess the risk of insolvency and that assessment influences the decision to make a payment. At the same time the business is able to continue to take advantage of consumers who are unable to assess that risk. He said:

> The only justification – to me – for not linking the timescale to preferences and having a 6 month period (at least) would be that there would be no (or almost no) pre-payments that far ahead.

Conclusion

8.104 Looking at the issue again, we can see good arguments for aligning the period with insolvency legislation, which is also designed to cover the "run up" to insolvency, when problems start to become apparent.

8.105 Six months would also provide protection for a greater proportion of consumer money where consumers had made regular payments over time, as occurred in Farepak: those payments made within six months of insolvency would give rise to a preferred claim. Any older payments (such as where a consumer had made 10 or 12 monthly prepayments before the company went insolvent) would give rise to an unsecured claim, as at present.

CONCLUSION

8.106 Giving preferential status to consumer claims involves a value judgement. In essence, the question is how far losses should fall on consumers or on banks and other institutional lenders. That is a political decision, which should be made by those who are elected to make these judgments.

8.107 If the Government does wish to act to protect consumers on retailer insolvency, our aim is to provide a range of possible options. Our proposed “limited preference” is one such option. It is intended to address the most serious cases, such as Farepak, World of Leather and MFI, where the business took large cash payments from consumers without providing any form of protection. These cases can cause significant public disquiet and undermine the perceived legitimacy of the law.

8.108 It is a solution of last resort. Its advantage is that it would apply to all classes of business, including (for example) utility companies which take prepayments by direct debit; and online retailers which use the new payment methods described in Chapter 7, which do not provide the possibility of chargeback.

8.109 We recommend that if the Government wishes to increase the protection given to consumer deposits in those cases which cause particular public disquiet it should consider this option.

RECOMMENDATIONS

Recommendation 4a: The Government should consider giving preferential status to a limited number of consumer claims, which would rank below preferential claims from employees, but above those from floating charge holders.

Recommendation 4b: Under this option, a consumer claim would have preferential status if it met all of the following criteria:

(1) The claimant is a consumer as defined in section 2(3) of the Consumer Rights Act 2015. That is, the claimant is “an individual acting for purposes that are wholly or mainly outside that individual’s trade, business, craft or profession”.

(2) The claim relates to a prepayment. In other words, the consumer has paid money to the insolvent business (or has parted with goods with a money value), and did not receive goods or services in exchange at the time nor have they been received since.

(3) The consumer has paid £250 or more during the six months immediately prior to the insolvency, either in a single transaction or in a series of linked transactions.

(4) The consumer used a payment method which did not offer a chargeback remedy, and the prepayment is not protected in any other way, for example through insurance or trust arrangements.

We discuss the impact of this option in Appendix D.[41] If the decision is taken to proceed with the option, a further impact assessment would need to be prepared.

[41] From para D.13.

CHAPTER 9
TRANSFER OF OWNERSHIP

9.1 In some cases, a consumer will have paid for goods which are still in the retailer's possession when it becomes insolvent. Questions then arise about who owns the goods. If ownership has been transferred to the consumer, the goods will not form part of the retailer's general asset pool: instead they belong to the consumer and should be made available to them. If ownership has not been transferred, the administrator can retain the goods and sell them to someone else.

9.2 The case histories provided by Citizens Advice show that this is a live issue. In this example, the consumer bought furniture for around £2,400:

> Because our flat was in a state [the trader] told us that they would store our furniture until we were ready for delivery.... Our flat is now nearly there, so I tried to call [the trader] last week, to arrange a date to have our furniture delivered, only to discover that they had gone into receivership. I am horrified. I paid my money in good faith trusting that I would get what I had paid for.

9.3 Alternatively, goods may be left for alteration:

> We ordered some curtains, paid for them and had them shortened by the shop... We called in today to collect them and were told that the shop had gone into receivership as of 12 noon yesterday and that we couldn't have the curtains as they were assets of the company and the assets were frozen. Surely if we have paid for them, they are no longer the company's assets but they are our assets and we should have been able to pick them up?

9.4 The law on this issue is stated in complex and technical rules. The rules were developed for commercial contracts and codified in statute in 1893. Since then, they have been restated but not changed in their substance. In the Consultation Paper we argued that they could cause confusion and operate harshly when applied to consumer sales.[1] We proposed simpler rules which would allow consumers to receive goods which had been identified for them and paid for.

9.5 Here we start by setting out the current law. We then look at the responses to the consultation before setting out our recommendations.

CURRENT LAW

Ownership and risk

9.6 The law distinguishes between the passing of "ownership" and the passing of "risk".

[1] Consultation Paper, para 13.6.

9.7 The question of who owns the goods is relevant if the seller becomes insolvent. By contrast, the question of when risk passes is relevant if the goods are damaged or destroyed. If the damage happens before risk has passed to the buyer, the seller bears the loss – but any damage to the goods after risk has passed is the buyer's problem.

9.8 Under commercial contracts, the general rule is that ownership and risk pass at the same time.[2] However, the parties are free to contract on a different basis.

9.9 For consumer contracts, risk and ownership pass at different times. The relevant provisions on the passing of risk are now in section 29 of the Consumer Rights Act 2015 which provides that risk will not pass to a consumer purchaser until the goods are in the physical possession of the consumer (or someone nominated by the consumer).[3] Any damage to goods before delivery (including in transit to the consumer with a retailer-nominated courier) is therefore the responsibility of the retailer.

Transfer of ownership: the current statutory provisions

9.10 The Consumer Rights Act 2015 was intended to codify the law of consumer sales, replacing many of the provisions of the Sale of Goods Act 1979 (the 1979 Act) in the consumer context. However, the provisions on transfer of ownership were not changed. Instead, section 4 (headed "Ownership of goods") refers the reader back to the relevant provisions in the 1979 Act. These are substantially the same as those in the original Sale of Goods Act 1893.

9.11 As we see below, the rules are complex. Different rules apply for "specific goods", compared with "unascertained or future goods". They also use the somewhat old-fashioned terminology of "property" passing. We prefer to use the terminology of "ownership" transferring from seller to buyer.

Specific goods

9.12 Section 61(1) of the 1979 Act defines specific goods as goods "identified and agreed upon at the time a contract of sale is made".

9.13 Section 17(1) of that Act provides the general rule that where there is a contract for the sale of specific or ascertained goods, property in the goods is transferred to the buyer when the parties to the contract intend it to pass. Section 18 sets out the various rules for ascertaining what the intention of the parties is where a different intention is not apparent.

9.14 Rule 1 of section 18 states:

> Where there is an unconditional contract for the sale of specific goods in a deliverable state the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment or the time of delivery, or both, be postponed.

[2] Sale of Goods Act 1979, s 20.

[3] Implementing the Directive on Consumer Rights (2011/83/EC), art 20.

9.15 Rule 2 states:

> Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until the thing is done and the buyer has notice that it has been done.

9.16 The initial starting point is therefore that property in the goods passes at the time the contract is made. However the goods must be "in a deliverable state", as defined in section 61(5):

> Goods are in a deliverable state within the meaning of this Act when they are in such a state that the buyer would under the contract be bound to take delivery of them.

Specific goods: applying the rules in practice

9.17 In the Consultation Paper we commented that the application of these rules was unclear. We gave an example where a consumer chooses and pays for a specific diamond ring and leaves it with the retailer to be inscribed. If the retailer becomes insolvent before the inscription is made, who owns the ring? This is a matter of construction of the particular contract.[4]

9.18 It could be argued that the consumer does not own the ring, because the inscription is a condition of the contract of sale and the buyer would not be bound to take delivery until the inscription had been made. This seems harsh in an insolvency situation where, without ownership, a consumer who had paid for a valuable ring would be left with an unsecured claim.

9.19 On the other hand, it could be argued that the inscription is merely a supplemental obligation and not a condition of the sale contract. It could even be a separate contract altogether. If so, the consumer would be entitled to claim the ring from the administrator.

9.20 Little guidance is provided by the case law, as much of it is concerned with when risk passes in commercial contracts and the principles are difficult to apply in a consumer context.[5] We think it is undesirable that the ownership of goods should be so unclear. While the courts might construe the law to benefit a consumer, in practice it is usually the administrator who is interpreting the rules. As administrators owe duties to all creditors they are likely to err on the side of caution and instruct shop staff not to release such property to prepaying consumers.

[4] See Benjamin, *Sale of Goods* (9th ed, November 2014) para 5-032 and fn 181 and 182.

[5] *Underwood Ltd v Burgh Castle Brick & Cement Syndicate* [1922] 1 KB 343 concerned industrial equipment which weighed thirty tons and was bolted to and embedded in concrete, requiring extraction and dismantling before it could be considered to be in a deliverable state. *Rohit Kulkarni v Manor Credit (Davenham) Ltd* [2010] EWCA Civ 69 is a consumer case: a car was held not to be in a deliverable state if its registration plates were not attached. However, in that case the dealer had obtained the car on hire purchase terms and was not authorised to sell.

Unascertained goods

9.21 In many cases, the specific goods to which the contract relates have yet to be identified. For example, where a consumer buys goods online, the retailer has the freedom to select which item among the many in the warehouse will be used to fulfil the contract. This is a contract for “unascertained goods”. Alternatively, the goods may not yet have been made (“future goods”).

9.22 Section 16 of the 1979 Act states that property in goods cannot generally be transferred to the buyer unless and until the goods have been ascertained. Rule 5(1) of section 18 sets out when property passes in a contract for the sale of unascertained goods in the absence of any contrary intention:

> Where there is a contract for the sale of unascertained or future goods by description, and goods of that description and in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, the property in the goods then passes to the buyer; and the assent may be express or implied, and may be given either before or after the appropriation is made.

9.23 Thus property passes when goods are “unconditionally appropriated” to the contract. Rule 5(2) provides one example of where unconditional appropriation takes place: that is where the seller delivers the goods to the buyer or carrier and does not “reserve the right of disposal”. However, this is not an exhaustive definition. Other actions may also be sufficient to unconditionally appropriate goods to a contract.

9.24 Since 1893, the meaning of the expression has been considered in several cases,[6] perhaps most prominently in *Carlos Federspiel & Co v Charles Twigg & Co*.[7] In that case the sellers manufactured bicycles to the buyer’s order and packed them in containers labelled with the buyer’s name and address. Before the goods could be shipped, the sellers became insolvent. It was held that the goods had not been unconditionally appropriated to the contract. Mr Justice Pearson said:

> A mere setting apart or selection by the seller of the goods which he expects to use in performance of the contract is not enough. If that is all, he can change his mind and use those goods in performance of some other contract and use some other goods in performance of this contract. To constitute an appropriation of the goods to the contract, the parties must have had, or be reasonably supposed to have had, an intention to attach the contract irrevocably to those goods so that those goods and no others are the subject of the sale and become the property of the buyer.[8]

[6] See, for example, *Healy v Howlett & Sons* [1917] 1 KB 337 and *Laurie & Morewood v John Dudin 7 Son* [1926] 1 KB 223.

[7] [1957] Lloyd’s Rep 240.

[8] Above, at 255.

9.25 However, the law on this issue is very unclear. The *Carlos Federspiel* case should be contrasted with the earlier case of *Aldridge v Johnson*[9] where the claimant agreed to buy 100 quarters of barley out of 200 which he had seen in bulk. It was agreed that he would send 200 sacks for the barley, which the seller would fill and send to the claimant. The seller filled 155 sacks but, on the eve of his bankruptcy, emptied them back into the bulk. It was held that property in the barley in the 155 sacks had passed. Mr Justice Pearson discusses this case in the *Carlos Federspiel* case, saying:

> there may be first an appropriation, constructive delivery, whereby the seller becomes bailee for the buyer, and then a subsequent actual delivery involving actual possession.[10]

Unascertained goods: applying the rules in practice

9.26 This leaves the question of what acts might amount to unconditional appropriation. In the Consultation Paper we quoted Professors Howells and Twigg-Flesner:[11]

> The generally accepted position is that such setting aside, labelling, packing etc for the buyer by the seller is insufficient; and that the goods have not been irrevocably committed to the contract until the seller does the last act they must do before surrendering control over the goods. This last act might be, for example, handing them to a courier for delivery to the customer or sending an invoice detailing the specific goods to be supplied under the contract.

9.27 In his consultation response, Professor Michael Bridge disagreed that sending an invoice specifying goods could be sufficient. Rather, he said, "in practical terms, it means delivery".

9.28 We think that ownership is not only transferred on delivery. Other acts may also be sufficient to amount to "unconditional appropriation". For example, if a consumer examines the goods and accepts them, we think ownership would be transferred, even if (as in the first Citizens Advice case history) the consumer asked the retailer to store the goods.[12] Similarly, we think ownership may be transferred when the goods are altered or inscribed in a way which is personal to the consumer: this would meet the test that the parties may reasonably be supposed to have had "an intention to attach the contract irrevocably to those goods".[13]

[9] (1857) 7 E&B 885, 119 ER 1476.

[10] [1957] Lloyd's Rep 240 at 255.

[11] G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) para 8.19.

[12] See *Aldridge v Johnson* (1857) 7 E&B 885, 119 ER 1476. This is discussed in D Sheehan *The Principles of Personal Property Law* (Hart Oxford 2011) at p 45. We are grateful to Professor Sheehan to drawing this to our attention.

[13] *Carlos Federspiel & Co v Charles Twigg & Co* [1957] Lloyd's Rep 240 at 255.

9.29 In the Consultation Paper we commented that the test was not as clear as it should be. We thought instead that ownership should be transferred as soon as goods were labelled with the customer's name or set aside for a specific consumer.

CONSULTATION PROPOSALS

9.30 In the Consultation Paper, we provisionally proposed new statutory rules about when a consumer acquires ownership of goods:

(1) For specific goods, which are identified at the time of the contract, we thought that ownership should be transferred when the contract is made, even if the retailer has agreed to alter the goods for the customer.

(2) For unascertained or future goods, we thought that ownership should be transferred when the goods are identified for the fulfilment of the contract. This would include labelling the goods, setting them aside for the customer, or altering them for the customer's specification.

9.31 We commented that these new rules would have only a limited effect. They would not apply to the great majority of prepayments, where goods have been paid for (in full or in part) but have not been identified. However, we thought they would be clearer to apply. They would also be perceived as less obviously unfair to consumers.

9.32 We considered and rejected a more radical proposal which would give consumers an ownership right in unascertained goods as soon as the contract was made.[14] We thought that a wider rule may be difficult to apply in practice. Furthermore, it could result in a large proportion of the retailer's stock belonging to consumers, diminishing the assets available to other creditors.

Responses

9.33 These proposals received a mixed response. The 28 responses we received were evenly split between those who agreed that the rules should be changed, and those who did not.[15]

9.34 The five consultees representing consumer interests were all in favour of the provisional proposals. Their concerns focused on the unfairness and perceived injustice of the current rules. As Citizens Advice put it, "clients could not understand why goods which they had already paid for, and had been told would be delivered, were available for other consumers to pay for and take away".

9.35 The proposals also received some support from other groups. For example, Chartered Accountants Ireland thought certainty would help administrators in deciding whether or not to fulfil outstanding orders.

9.36 However, most insolvency practitioners opposed the proposals.[16] In fact, all the responses which opposed the proposals came from insolvency practitioners.

[14] Consultation Paper, paras 13.34 to 13.36.

[15] 11 (39%) agreed that the rules should be changed, 11 (39%) disagreed, and six (21%) marked "other".

9.37 Several insolvency practitioners argued that the proposals were actually much more radical than we had suggested. For example, R3 described the amendments as "fundamental" and having "far-reaching consequences" with the potential to upset retention of title arrangements, security arrangements, insurance and tax. PwC made a similar point:

> Any change of this sort would only serve to increase complexity in the competing claims of different stakeholders to the same goods - adding consumers to a list that could include some or all of: Retention of Title claims, general or special liens, resellers, and in Scotland, landlords under hypothec.

9.38 KPMG added:

> In practice it will incur significant additional costs in the logistics of repatriating goods to consumers. The additional time will be incurred in reviewing the validity of the claims to ownership and then attending various locations to oversee the collection.

9.39 By contrast, the City of London Law Society thought that the proposals would have a relatively limited effect - even suggesting that they were too minor to justify legislation.

9.40 The academics provided more detailed responses. Professor Sheehan generally supported the proposed change for specific goods, but he did not see the benefits of the change in relation to unascertained goods.

ANSWERING INSOLVENCY PRACTITIONERS' CONCERNS

9.41 We do not think that these changes would have the fundamental impact feared by insolvency practitioners.

Already a need to review consumers' claims to ownership

9.42 Under the current law, some stock on retailers' premises may already belong to consumers – as when consumers buy specific goods which have been put into a deliverable state, or where the consumer has seen and accepted the goods. We would be concerned if insolvency practitioners did not already have systems for reviewing consumers' claims to ownership and arranging for goods owned by consumers to be handed over.

No clash with retention of title clauses

9.43 We do not think that there is any clash between a retention of title clause and the consumer's ownership of goods. Generally a retention of title clause does not restrict the retailer's ability to resell the goods in the course of its business; that would effectively freeze the retailer's business and frustrate the whole point of the transaction. For that reason, retention of title clauses often expressly authorise the retailer to resell goods.

[16] 11 of 13 insolvency practitioners answered against the proposals; Chartered Accountants Ireland were in favour, and the Institute of Chartered Accountants in England and Wales answered "other".

9.44 However, even in the absence of such express authority, the courts will imply that the retailer has authority to resell the goods. For example in *Four Point Garage Ltd v Carter* the sellers supplied cars to a company under a reservation of title clause believing the company was in the business of letting cars on hire.[17] In fact the company sold a car to the defendant and then became insolvent before paying the seller. It was held that a power of resale was implied in the contract and therefore the defendant, a buyer in good faith, obtained good title.

9.45 Where a retailer has either the express or implied authority of the seller to resell the goods, a consumer will take them free of any retention of title clause. The same rules apply whether ownership is transferred on delivery or at some earlier point.

Warehouse and deliverers' liens

9.46 Where the goods are in a warehouse, and the retailer has not paid the warehouse for its services, the warehouse may have a lien over those goods. This means that the warehouse can hold onto the goods until its bill has been paid. The same is true for an unpaid delivery company.

9.47 Where ownership of the goods has passed to a consumer, we think that the warehouse could also enforce its lien against the consumer. In other words, the buyer would have to pay the warehouse for the release of their goods. Although the law on this is not entirely clear, this conclusion sits with the notion that a seller cannot confer a better title than it has.[18]

9.48 This leads to the practical question of what happens if the warehouse has stored 100 sofas and ownership of ten sofas has passed to ten individual consumers. Administrators would be entitled to pay only part of the whole bill, requiring each consumer to pay the warehouse for release of their individual items. Alternatively, the administrator could negotiate for the release of all goods and ask the consumer to pay a proportion of the fee. In some cases, the administrator may decide that the commercial advantages of preserving goodwill would justify the fee being waived.

9.49 We can see that this is an added complexity. However, the issues already exist under the current law, for example where an unpaid delivery company holds goods when a seller becomes insolvent. In practice, we think it would be possible to resolve these issues without major difficulties.

[17] [1985] 3 All ER 12.

[18] Although we did not find any cases which dealt with this point directly, many cases have enforced a lien against a third party owner, even though the owner was not responsible for the debt: see *The Singer Manufacturing Company v The London & South Western Railway Co* [1894] 1 QB 833. The issue will depend on whether the consumer had given consent (express or implied) to the lien. In *Jarl Tra AB v Convoys Ltd* [2003] EWHC 1488 (Comm) the court found that a wharfinger's lien was neither unusual nor unreasonable enough for it to be assumed that the claimant had not consented to it. See also *K Chellaram & Sons (London) v Butlers Warehousing & Distribution* [1978] 2 Lloyd's Rep 412 and *Jowitt & Sons v Union Cold Storage Company* [1913] 3 KB 1.

Other concerns

9.50 Insolvency practitioners also mentioned tax, security arrangements and insurance. We do not see any of these considerations being affected by a small change in the rules of when ownership passes. Security and insurance relate to the passing of risk – and, as we have seen, this is no longer linked to rules on the transfer of ownership. Similarly, VAT depends on the time of the contract and payment – not when ownership passes.

SHOULD THE LAW BE REFORMED?

9.51 Our proposals in this area were small and limited. They would not protect the vast majority of consumers who have paid for goods which have not been delivered. We are mindful of the comments from the City of London Law Society that they may be too minor to justify legislative reform.

9.52 On the other hand, the Law Commission has long argued that the law on consumer sales should be rewritten in plain language and brought together in one place, so that it is readily accessible to both consumers and retailers.[19] The Consumer Rights Act 2015 has gone a long way to achieve this objective, but it does not include updated rules on when ownership is transferred. Instead, section 4 of the Act imports the rules from the 1979 Act, which were written in nineteenth century language for commercial contracts.

9.53 The case histories we received from Citizens Advice showed that issues of ownership are sometimes a real concern to consumers who struggle to understand why the goods they have chosen and paid for are being sold to others. We think that consumers deserve a clear statement of the law in modern terms about when they do (or do not) own goods left with an insolvent retailer.

9.54 The responses from consultees also suggest some possible misunderstandings or disagreements about the effect of the current law. Clearer, updated statutory rules would also benefit administrators and shop staff. We make recommendations for updated rules below.

SPECIFIC GOODS

9.55 We recommend that, in consumer contracts for specific goods, ownership should pass on conclusion of the contract, even where the seller is required to do something further to the goods (such as adapt the goods to the buyer's specifications).

9.56 If the property is physically not in a deliverable state, we think that ownership should still be taken to have been transferred to the consumer - though it would be for the consumer, at their own expense, to pay for it to be put into a deliverable state and removed from the retailer's premises. This might arise, for example, where a consumer has purchased a display item (such as a kitchen suite) which must be dismantled before it can be taken away.

[19] Law Commission, *Simplifying Consumer Law: A response from the Law Commission to the DTI's Consultative Document on Consumer Strategy*, October 2004.

9.57 In the example we used of a consumer buying a ring and leaving it with the retailer for inscription, we think that a court could construe the contract to find that property had passed.[20] However, we suspect that insolvency practitioners might be more cautious and might instruct staff not to release that item. The consumer may not have the resources, or the will, to go to court.

9.58 We think that removing the requirement that goods be in a deliverable state would provide clarity and make it easier for insolvency practitioners to release stock to prepaying consumers where appropriate.[21] This would also address the perception of the law as unjust. It would be fairer to consumers and more aligned to common expectations.

UNASCERTAINED GOODS

Provisional proposals

9.59 In the Consultation Paper we argued that the meaning of unconditional appropriation in a consumer context was too uncertain for administrators, shop assistants and consumers to apply consistently in practice. We also thought that it could operate harshly against consumers who had paid for goods which had been labelled or set aside for them.

9.60 We provisionally proposed that ownership should be transferred when goods are identified for fulfilment of the contract.[22] We said that this should include cases where the goods were labelled with the customer's name or order number, set aside to await collection, or altered to the customer's specification.

Criticisms

9.61 These proposals proved to be more controversial than those for specific goods. The first concern was that the concept of "identification" was not necessarily clearer than the concept of "unconditional appropriation". As Professor Sheehan put it, "Getting hung up on unconditional appropriation vs identification is just to get hung up on words".

9.62 The second concern was about the effect of placing a label on goods, given that it could be removed subsequently. If a shop assistant placed a label on goods and then removed it, would this amount to the tort of conversion under our recommended rules? The concept of unconditional appropriation was thought to have the advantage that it did not cover conditional acts.

[20] This is a matter of contract construction. See from para 9.17 above.

[21] See also G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) paras 8.59 to 8.69, where they argue for the abolition of the deliverable state rule.

[22] We noted that the concept of identification was used in the Draft Common Frame of Reference, which brings together common principles from European Contract Law - Consultation Paper, para 13.29.

Conclusion

9.63 As an overall policy objective, we do not think that consumers can or should have property rights in generic, or undifferentiated goods. However, buyers should have ownership of particular goods that have been identified as relating to that contract.

9.64 On the other hand, we accept that merely replacing the word "unconditional appropriation" with the word "identification" would not bring the clarity which administrators and shop staff need. We now think that it would be useful to have a non-exhaustive list of events and circumstances which would be sufficient to identify goods to the contract.

Circumstances where goods are identified to the contract

9.65 We recommend that any legislation should include a non-exhaustive list specifying that goods are identified to the contract when:

(1) the goods have been altered to the consumer's own specifications;

(2) the goods have been labelled with the consumer's name or set aside for the consumer in a way which is intended to be permanent;

(3) the consumer is told that goods bearing a unique identifier will be used to fulfil the contract;

(4) the consumer has physically examined and accepted the goods;

(5) the goods are handed to a courier to be delivered to the consumer; or

(6) the goods are delivered to the consumer.

9.66 We think that ownership should only be transferred if the labelling or setting aside are intended to be permanent. Of course, in some circumstances, a label may be intended to be permanent and may then be switched. If this is done when the retailer is still solvent, it is unlikely to be dishonest. If the switch is for an equivalent product, the consumer will not suffer any loss and so will have no cause to claim for conversion.

9.67 If labels were removed following an insolvency, this would cause loss to the consumer. In some circumstances it may be sufficiently dishonest to amount to theft. In practice, of course, the consumer may be unaware of the switch. However, it is right to assume that administrators are honest and wish to act within the law. They would therefore give instructions that labelled products were to be handed to consumers.

Unique goods

9.68 In the Consultation Paper we suggested that ownership would also pass where goods were unique. For example, if only one customer ordered a red polka dot sofa and only one such sofa was delivered to the retailer, that sofa would be identified to that contract. However, if five customers ordered red polka dot sofas and five were delivered, it would be impossible to identify which sofa related to which contract. In this case ownership would not pass until the relevant sofa was labelled or set aside.

9.69 On reflection, we think the concept of unique goods could lead to arbitrary results. Whether ownership had passed would depend not on the contract between consumer and retailer but on what other goods happened to be in the warehouse at the time. We now think that the fact that only one red polka dot sofa had been delivered would not be enough to show that ownership had passed.

PAYMENT

9.70 The current default rules on transfer of ownership do not require goods to be paid for before ownership is transferred. If retailers wish to retain property rights until invoices have been paid they must contract for this specifically. However, the retailer or administrator is not be obliged to release the goods until the consumer had paid for them in full, as an unpaid seller has a lien on the goods for the price.[23]

9.71 We recommend retaining this approach in the new consumer rules, as this protects not only those who have paid in full but also those who have paid substantial deposits. Ownership may be transferred before the goods are fully paid for. However, the seller would have a right to retain the goods until the whole of the price has been paid.

MANDATORY RULES?

9.72 The current rules relating to the passing of property in the Sale of Goods Act 1979 are presumptions which impute an intention to the parties where they have not otherwise evidenced one. They may therefore be rebutted if it appears that the parties intended property to pass at an earlier or later point in time. However, in a consumer context, rules such as those governing the transfer of risk in the Consumer Rights Act 2015 are mandatory.

9.73 In the Consultation Paper, we asked if the proposed new rules on transfer of ownership should be mandatory and therefore apply to all consumer contracts. Alternatively, should the parties to a contract be allowed to agree alternative terms? We thought that it would be simpler to provide mandatory rules to apply in all cases, as consumers and retailers were unlikely to turn their minds to this technical issue.

9.74 We received 13 substantive responses to this question: 11 said that the rules should be mandatory and only two thought that the parties should be able to agree alternative terms. Respondents representing consumer interests said mandatory rules would provide clarity. The Competition and Markets Authority expressed concern that allowing parties to agree alternatives could lead to unfair terms being imposed on consumers.

[23] Sale of Goods Act 1979, s 39(1).

9.75 On another law reform project, we considered whether some terms should be mandatory in the context of consumer insurance. In that instance, we recommended that any contract term which would put the consumer in a worse position than the new default rules should be of no effect.[24] We think that a similar approach would be appropriate here.

NO IMMEDIATE TRANSFER OF OWNERSHIP

9.76 In the Consultation Paper we mooted the immediate transfer of ownership (at the time of the contract) as a possible alternative to "unconditional appropriation" or "identification". Professors Howell and Twigg-Flesner explained this as follows:

> As each purchase was made, one such item would be treated as belonging to that customer. If there were no items in stock when the purchase was made (or if the stock was all committed to earlier customers), new incoming stock purchased by the seller would be treated as owned by customers according to when their purchase had been made.
>
> This would mean that ownership would pass at the time of the contract if the goods in question were in stock; or, if no such goods were in stock when the contract was made, as soon as the next item of these goods came into stock.[25]

9.77 In the Consultation Paper we argued against this option on the grounds that it would be difficult to apply in practice: to allocate stock one would need to know the date and time of each order. It would also result in a much larger proportion of the retailer's stock belonging to consumers and would diminish the assets available to other creditors. We asked if there were any arguments in favour of transferring ownership to consumers immediately upon the conclusion of the contract.

9.78 We received 15 responses. Three consumer groups supported immediate transfer. The Farepak Victims Committee, Citizens Advice and Jessica Morden MP all thought this would be fairer to consumers. Jessica Morden MP said:

> The item or items being bought should be the consumer's property immediately and this would rebalance the system in favour of ordinary consumers in the event of insolvency.

9.79 However, other stakeholders did not favour immediate transfer of ownership. We do not think there is sufficient support for such a radical change, and we do not recommend it, for the reasons given in the Consultation Paper.[26]

[24] Section 10(1) of the Consumer Insurance (Disclosure and Representations) Act 2012 states: A term of a consumer insurance contract, or of any other contract, which would put the consumer in a worse position as respects the matters mentioned in subsection (2) than the consumer would be in by virtue of the provisions of this Act is to that extent of no effect.

[25] G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) para 8.79.

[26] See para 7.74.

RECOMMENDATIONS

Recommendation 5a: We recommend that section 4 of the Consumer Rights Act 2015 should be amended to include new rules about when a buyer acquires ownership of goods in a contract for the sale of goods from a business to a consumer.

Recommendation 5b: The new rules should state that:

(1) For specific goods, which are identified at the time of the contract, ownership should be transferred at the time the contract is made. This should apply even if the retailer has agreed to alter the goods in some way before the consumer takes possession.

(2) For unascertained or future goods, which are not identified at the time of the contract, ownership should be transferred when goods are identified for fulfilment of the contract.

(3) The legislation should include the following non-exhaustive list of events and circumstances which would be sufficient to identify goods to the contract:

(a) the goods have been altered to the consumer's own specifications;

(b) the goods have been labelled with the consumer's name or set aside for the consumer in a way which is intended to be permanent;

(c) the consumer is told that goods bearing a unique identifier will be used to fulfil the contract;

(d) the consumer has physically examined and accepted the goods;

(e) the goods are handed to a courier to be delivered to the consumer; or

(f) the goods are delivered to the consumer.

Recommendation 5c: These rules should be mandatory: that is, any term in the contract which would put the consumer in a worse position should be of no effect.

Recommendation 5d: The seller should have a right to retain the goods until the whole of the price has been paid.

CHAPTER 10
LIST OF RECOMMENDATIONS

This chapter brings together all of the recommendations contained in this Report.

CHRISTMAS AND SIMILAR SAVINGS SCHEMES

Recommendation 1a: Legislation should apply to any scheme which takes consumer prepayments in return for goods, services, or vouchers and which:

(1) is marketed as being suitable as a savings mechanism; or

(2) would be understood by the "average consumer" as being a form of savings.

Recommendation 1b: The legislation should require consumer payments to such schemes to be adequately protected, for example through trust arrangements or insurance. The protection should be sufficient to ensure that the promised goods, services or vouchers can be provided.

Recommendation 1c: The legislation should be made under the new regulation-making power recommended at 2a below.

Recommendation 1d: Schemes run by microbusinesses which do not take prepayments of more than £100 from an individual consumer should be excluded from regulation. **(Chapter 5)**

POWER TO REQUIRE SECTOR SPECIFIC REGULATION

Recommendation 2a: The Secretary of State should have a power to require protection of consumer prepayments in sectors which, in the opinion of the Secretary of State, pose significant risk to consumers.

Recommendation 2b: Legislation should allow for prepayment protection by trust, insurance or bonding or a combination thereof.

Recommendation 2c: Any regulations made should be enforced by Trading Standards and the Competition and Markets Authority by civil or criminal measures. **(Chapter 6)**

CHARGEBACK

Recommendation 3a: The Insolvency Service should produce an issue of Dear IP to give insolvency practitioners best practice guidance on:

(1) Advising consumer creditors who have paid by card to contact their card issuer to raise a chargeback.

(2) Advising consumers that further information on chargeback can be found in the UK Cards Association guide to chargeback.

(3) Providing on the retailer's website a confirmation that the company is in administration or liquidation, in a form which consumers can provide to their card issuer as evidence of the same.

(4) Making available to consumers other evidence or information which a card issuer may reasonably require.

Recommendation 3b: Insolvency practitioners and card issuers (through the appropriate representative bodies) should agree the form and content of a document which the insolvency practitioner will put on the website of an insolvency retailer and which the card issuer will accept from the consumer as evidence of the insolvency.

Recommendation 3c: The UK Cards Association should prepare a code of best practice for card issuers concerning the provision of information to consumers about chargebacks and the evidential requirements for raising a chargeback.

Recommendation 3d: The UK Cards Association should prepare a chargeback guide for consumers. It should include greater information on time limits and complaints. Card issuers and card schemes should link to this document, which should be kept up to date. **(Chapter 7)**

CONSUMERS' STATUS IN THE INSOLVENCY HIERARCHY

Recommendation 4a: The Government should consider giving preferential status to a limited number of consumer claims, which would rank below preferential claims from employees, but above those from floating charge holders.

Recommendation 4b: Under this option, a consumer claim would have preferential status if it met all of the following criteria:

(1) The claimant is a consumer as defined in section 2(3) of the Consumer Rights Act 2015. That is, the claimant is "an individual acting for purposes that are wholly or mainly outside that individual's trade, business, craft or profession".

(2) The claim relates to a prepayment. In other words, the consumer has paid money to the insolvent business (or has parted with goods with a money value), and did not receive goods or services in exchange at the time or since.

(3) The consumer has paid £250 or more during the six months immediately prior to the insolvency, either in a single transaction or in a series of linked transactions.

(4) The consumer used a payment method which did not offer a chargeback remedy, and the prepayment is not protected in any other way, for example through insurance or trust arrangements. **(Chapter 8)**

TRANSFER OF OWNERSHIP

Recommendation 5a: Section 4 of the Consumer Rights Act 2015 should be amended to include new rules about when a buyer acquires ownership to goods in a contract for the sale of goods from a business to a consumer.

Recommendation 5b: The new rules should state that:

(1) For specific goods, which are identified at the time of the contract, ownership should be transferred at the time the contract is made. This should apply even if the retailer has agreed to alter the goods in some way before the consumer takes possession.

(2) For unascertained or future goods, which are not identified at the time of the contract, ownership should be transferred when goods are identified for fulfilment of the contract.

(3) The legislation should include the following non-exhaustive list of events and circumstances which would be sufficient to identify goods to the contract:

(a) the goods have been altered to the consumer's own specifications;

(b) the goods have been labelled with the consumer's name or set aside for the consumer in a way which is intended to be permanent;

(c) the consumer is told that goods bearing a unique identifier will be used to fulfil the contract;

(d) the consumer has physically examined and accepted the goods;

(e) the goods are handed to a courier to be delivered to the consumer;

(f) the goods are delivered to the consumer.

Recommendation 5c: These rules should be mandatory: that is, any term in the contract which would put the consumer in a worse position should be of no effect.

Recommendation 5d: The seller should have a right to retain the goods until the whole of the price has been paid. **(Chapter 9)**

(Signed) DAVID BEAN, *Chairman*
NICK HOPKINS
STEPHEN LEWIS
DAVID ORMEROD
NICHOLAS PAINES

PHIL GOLDING, *Chief Executive*
14 June 2016

APPENDIX A
LIST OF CONSULTEES

A.1 The following bodies and individuals responded to our consultation, which ran from June to September 2015:

Insolvency practitioners and representative bodies

Association of Business Recovery Professionals (R3)

Chartered Accountants Ireland

City of London Law Society (CLLS)

Deloitte

Insolvency Lawyers' Association (ILA)

Insolvency Practitioners Association (IPA)

Institute of Chartered Accountants of England and Wales (ICAEW)

Institute of Chartered Accountants of Scotland (ICAS)

KPMG

Moore Stephens

Richard Palmer

PwC

R3 Scottish Technical Committee (R3 STC)

Gift voucher sector

Acorne plc

Book Tokens Ltd

Into The Blue

Park Group plc

Signet Trading Ltd

Society of London Theatre

UK Gift Card and Voucher Association (UKGCVA)

Consumer interests/protection

Chartered Trading Standards Institute (CTSI)

CTSI Consumer Codes Approval Board (CCAB)

Citizens Advice

Debbie Harvey on behalf of the Farepak Victims Committee

Louise McDaid (individual affected by Farepak insolvency)

Jessica Morden MP (speaking in personal capacity after consulting victims of Farepak insolvency)

Academics

Professor Michael Bridge

Professor Duncan Sheehan

Professor Christian Twigg-Flesner

Card industry

UK Cards Association

MasterCard

Visa

Other

Competitions & Markets Authority (CMA)

Department of Enterprise Trade & Investment – Northern Ireland Insolvency Service (DETINI)

Association of British Insurers (ABI)

Chimera Insurance Agency (Insurance provider)

Correlation Risk Partners (Insurance provider)

Finance and Leasing Association

Transpact (escrow service)

Association of British Travel Agents (ABTA)

Home Insulations and Energy Systems Scheme (HIESS)

A.2 Between September 2014 and June 2016, the Law Commission met or otherwise corresponded with the following people and organisations with respect to the consumer prepayments project.

ABTA

Acorne

Barclays

Booksellers' Association

British Banking Association (BBA)

British Retail Consortium (BRC)

CERTASS

Chartered Trading Standards Institute (CTSI)

Chimera Insurance

Christian Twigg-Flesner

Citizens Advice

Civil Aviation Authority (CAA)

Competition and Markets Authority (CMA)

Correlation Risk Partners

Danish Financial Supervisory Authority

Deloitte

Department for Business, Innovation and Skills (BIS)

Department for Transport (DfT)

Double Glazing and Conservatories Ombudsman Scheme (DGCOS)

Duff & Phelps

Enterprise Insurance/IBG

EY

Farepak Victims Committee

FENSA

Financial Conduct Authority (FCA)

Financial Ombudsman Service (FOS)

Furniture Ombudsman

Green Deal Guarantee Company

HM Treasury

Home Insulation & Energy Systems Contractors Scheme (HIES)

Horticultural Trades Association

Insolvency Service

Institute of Chartered Accountants of England and Wales (ICAEW)

KPMG

MasterCard

National Book Tokens

Park Group

Payment Systems Regulator (PSR)

PwC

R3

Society of London Theatre

Tesco

Tony Allen (trading standards consultant)

TrustMark

UK Cards Association

UK Gift Card and Vouchers Association (UKGCVA)

Visa Europe

Which?

Worldpay

APPENDIX B
DIRECTORS' LIABILITY

B.1 A company's financial difficulties will usually have started well before a company enters administration. Administration is a difficult step for retailers, and will often of itself decrease the value of the business and lead to store closures and redundancies. It is therefore common for directors to try to save the company first, including talking to possible purchasers and lenders. Important stakeholders, such as secured lenders, are usually kept abreast of developments, but consumers are unlikely to realise that there is a problem.

B.2 This leads to difficult questions about whether directors should be accepting deposits from consumers, or selling gift vouchers, when they know that there is a substantial chance that those orders will not be fulfilled or vouchers honoured. This is a controversial issue – directors may genuinely believe that continuing to take prepayments may assist in saving the company, whereas cutting off this source of income could force the company into immediate insolvency. There is a fine, and sometimes imperceptible, line between good and bad decisions.

B.3 We commented in the Consultation Paper that it will often be human nature for directors to fight until the end to save their company. However, there will also be cases where directors act wilfully, perhaps for personal gain or to benefit an important creditor. The Government recently noted:

> Director misconduct is a moral hazard problem. This problem is caused by the perverse incentives, which, in turn, are created by limited liability. Under moral hazard, directors are more likely to engage in misconduct or take more risks if they are not personally responsible for the consequences of their actions.[1]

B.4 Here, we discuss the frequent calls for directors to be brought to account. We then summarise the three possible legal sanctions: wrongful trading, fraudulent trading and director disqualification, and note recent changes. Given that the Government has recently considered the issue of director disqualifications, and that it extends beyond the limited issue of consumer prepayments, we do not make any recommendations for further change in this Report.

CALLS FOR DIRECTORS TO BE HELD TO ACCOUNT

B.5 Even if directors act with good intentions, consumers are likely to be angry. Consumers, unlike secured creditors and floating charge holders, will usually have had no knowledge of the company's financial difficulties in the run up to insolvency. What they will perceive is that directors took money from consumers while apparently knowing that there was a good chance that those consumers would never receive anything in return.

[1] Impact assessment, 'Giving the court and Secretary of State (SoS) a power to make a compensatory award against a director, 5 June 2014. IA No: BIS INSS003. Available here.

B.6 An example is the World of Leather insolvency. Although a court later held that the directors had not acted in a manner prejudicial to creditors (including consumers), the issue of consumer prepayments received press coverage and was discussed in Parliament.

B.7 Jimmy Hood, at the time Member of Parliament for Clydesdale, said in Parliament:[2]

> Let us be clear that, from our constituents' point of view, and ours, we are talking about corporate robbery, and I want [the Minister for Trade] to tell us what will be done about it.

Perverse incentives

B.8 In some cases, directors' actions in delaying the decision to enter administration will not increase the overall loss to consumers generally (although different individuals will be affected depending on the timing of the administration). If a business depends on taking customer deposits and fulfilling orders, it is almost inevitable that it will have some unfulfilled orders in the pipeline whenever it goes into administration.

B.9 In some cases, however, delaying administration will increase the amount that consumers lose. This may happen when the business is seasonal and the entirety of the goods or services are provided at a specific time. It is especially true of Christmas hamper clubs. For example, in Farepak (discussed below), consumers lost more money when Farepak entered administration in October 2006 than they would have lost had Farepak stopped trading in August. Alternatively, a similar result may occur because there is a known surge in purchases at a particular time of year – such as purchases of gift vouchers just before Christmas. Fewer people would lose money if a business selling gift vouchers went into administration in September than if it did so in December.

B.10 The amount of money consumers lose may also be greater if the company tries to trade its way out of difficulty. An example would be a furniture firm which responds to its financial difficulties by offering spectacular discounts to prepaying consumers, or by increasing the amount of the deposit (for example, by asking for a 90% deposit rather than a 50% deposit).[3]

B.11 Where a company increases the amount of money it takes from consumers in the period leading up to administration and no trust arrangements are in place, this effectively transfers money from consumers to floating charge holders.

B.12 As we discuss in Chapter 8, this could give banks and other floating charge holders a perverse incentive to encourage directors to obtain more prepayments from consumers before administrators are appointed. Directors may be in a difficult position given the power which some lenders have over distressed companies.

[2] Hansard (HC), 24 May 2000, pt 3, col 253WH.

[3] Indeed, Uno, the parent company of World of Leather, accepted 100% deposits.

Concern about this issue

B.13 This issue has caused public disquiet over the years. The influential Cork report in 1982 was not in favour of giving preferential status to consumer creditors. However it did recommend greater protections against wrongful trading to cover these circumstances and suggested a provision that would allow directors to be held liable for wrongful trading. It commented that under its recommendations, if company directors were aware of financial difficulties and "continue[d] to accept payments in advance... without paying the money into a trust account", that would be evidence of wrongful trading for which the directors should be held liable.[4]

B.14 This is not the current legal position. As we discuss below, wrongful trading actions are extremely difficult to bring, and present a high hurdle to overcome. Following the collapse of Farepak, both the Office of Fair Trading (OFT) and Consumer Focus criticised the current state of the law, but it has proved difficult to introduce any legal changes.

LIABILITY FOR WRONGFUL TRADING

B.15 Liability for wrongful trading is set out in section 214 of the Insolvency Act 1986. It applies to directors who continued to trade when they: [5]

> knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

B.16 However, it goes on to state that directors are not liable if they took every step they ought to have taken to minimise the potential loss to the company's creditors.[6]

B.17 This provision is less onerous on directors than the Cork Committee's recommendations, and suffers from three flaws: it is difficult to bring an action; the test is difficult to meet; and it is unlikely to result in a payment to consumers. We examine each problem in turn.

Difficulties in bringing an action

B.18 Wrongful trading is not a criminal act. It is a civil claim which can only be brought by a liquidator or, as a result of amendments made by the Small Business, Enterprise and Employment Act 2015, an administrator.[7] It appears rare for liquidators to bring such actions. The Insolvency Service has identified 29 cases brought between 1987 and 2013 (a period of 27 years), of which liability was imposed in 11.[8] Of course, more cases may have been settled, but no figures are available for settlements.

[4] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558, para 1056.

[5] Insolvency Act 1986, s 214(2)(b).

[6] Insolvency Act 1986, s 214(3).

[7] Small Business, Enterprise and Employment Act, s 117, providing for a new section 246ZB in the Insolvency Act 1986.

[8] We are grateful to the Insolvency Service for providing these figures.

B.19 Consumers themselves are not entitled to bring a claim under this section. The OFT's review following Farepak questioned whether representative actions could be introduced in consumer protection legislation.[9]

B.20 Bringing a claim has significant costs. A liquidator will either have to pay for the litigation with assets from the estate (thereby potentially reducing the return to creditors if unsuccessful) or convince creditors to fund the action themselves. Initially, insolvency litigation was exempt from the Jackson reforms (which restrict the availability of "no win, no fee" conditional fee agreements), but this exemption was removed in April 2016.[10]

B.21 We are aware of one case in which the liquidator expressed concern that directors had taken deposits of up to 100% and failed to fulfil the relevant orders. Creditors in that case declined to fund an action against the directors.

A difficult test to meet

B.22 For directors to be held liable, the bar is set high. There must be "no reasonable prospect that the company would avoid going into insolvent liquidation", rather than a reasonable prospect that the company *would* go into insolvent liquidation. Thus, for example, even if there is a 60% chance that the company will go into liquidation, the 40% chance that it can be saved is enough for directors to continue trading without incurring liability.

B.23 As we discuss below, in relation to director disqualification, the courts will accept that directors were reasonable in pursuing any realistic option to avoid insolvency. It is irrelevant whether an independent bystander would conclude that insolvency was more likely than not.

Consumers are unlikely to receive payment

B.24 If a claim against a director for wrongful trading is successful then, under section 214 of the Insolvency Act 1986, the court "may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper". The wording of this section has three consequences:

(1) The amount of any contribution to be made by the director is at the court's discretion.

(2) As the director is personally liable for the amount, the amount that can be recovered depends on the director's personal assets.[11]

[9] Farepak: review of the regulatory framework, Advice from the Office of Fair Trading (December 2006) paras 48 to 52.

[10] https://www.gov.uk/government/speeches/insolvency-litigation; Legal Aid, Sentencing and Punishment of Offenders Act 2012 (Commencement No. 12) Order 2016.

[11] However, a director may have directors' and officers' liability insurance, a form of professional indemnity insurance, which may include cover for wrongful trading.

(3) Any contribution will go to the company's assets and thus be available for the general pool of secured and unsecured creditors. There is currently no way to direct any financial contribution under this section to a specific group of creditors.[12]

B.25 This differs from the Cork Committee recommendation, which would have allowed the court to direct that the money is paid to a particular class of creditors, such as consumers.[13]

LIABILITY FOR FRAUDULENT TRADING

B.26 There are two types of liability for fraudulent trading: civil liability under section 213 of the Insolvency Act 1986, and criminal liability under section 993 of the Companies Act 2006 and section 9 of the Fraud Act 2006.

B.27 Section 213 of the Insolvency Act 1986, similar to the wrongful trading provisions discussed above, allows liquidators to bring a claim for a contribution to the company's assets against persons who were knowingly parties to the fraudulent carrying on of the business, defined in section 213(1) as:

> …any business of the company [which] has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose…

B.28 This liability is civil; while the directors may be required to make a contribution to the company's assets, they will not incur criminal liability. The difficulties in bringing a claim for wrongful trading also apply here: actions may be costly to fund and any contribution will accrue to the company's assets (and thus the general body of creditors) rather than a particular class of creditors. In addition, it will be even more onerous for the liquidator to prove fraud than to meet the already difficult test set out for wrongful trading above.

B.29 Criminal liability is set out in section 993 of the Companies Act 2006. This provision makes it an offence to knowingly be a party to the carrying on of any business of a company with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose. Section 9 of the Fraud Act 2006 provides for the same offence in cases where the business is not a company (for example, a sole trader).

B.30 Here too the burden of proof for proving fraud is high: it must be shown, beyond reasonable doubt, that the parties involved had an intention to defraud creditors or sought to pursue a fraudulent purpose.

[12] The Small Business, Enterprise and Employment Act 2015 provides for compensation orders in the context of director disqualification proceedings, see from para B.38 below.

[13] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558, para 1797 and (4)(b) of the proposed draft clause at para 1806.

DISQUALIFICATION PROCEEDINGS

B.31 In practice, this is the main form of action brought against directors. The court has power to make a disqualification order against any director of an insolvent company whose conduct as a director of that company is shown to make them unfit to be concerned in the management of any other company.[14]

B.32 The Insolvency Service is in charge of investigating a director's conduct, and can seek a disqualification order in the name of the Secretary of State. It will also accept a voluntary "disqualification undertaking", which has the same effect but does not involve court proceedings.

B.33 There is no definitive list of behaviours which will constitute unfitness; rather, the court is to have regard to the entirety of the director's conduct, even if it does not fall within the wrongful trading provision, or any other provision, of the Insolvency Act 1986.[15] Trading while insolvent, or in the knowledge that insolvency is likely, is one ground for disqualification, though the decision will be taken in the round and other factors will also be considered. The court will not look narrowly at the test for wrongful trading.[16]

B.34 In the Consultation Paper we said that between January 2011 and February 2015, 4,419 directors were disqualified but that only 18 of them were concerned with allegations of trading while insolvent. Of those 18 cases, 16 directors gave a voluntary undertaking and the court made only 2 disqualification orders.[17]

B.35 As we discuss below, certain changes to the law came into force in May 2015. It is too early to tell whether more directors will be disqualified as a result. The annual figure for the year ending March 2016 was 1,208, almost the same as the 1,210 disqualifications in the year ending March 2015.[18] However, the latest figures suggest an increase: it has been reported that between January and March 2016 the Insolvency Service made 390 disqualifications, the largest quarterly number since 2010.[19]

B.36 It is rare for the courts to find against directors on the grounds that they knowingly continued trading while insolvent, though this may be an aggravating feature in other allegations of misconduct. As we see below, the courts tend to be sympathetic to directors who tried hard to save their companies, even if they were ultimately unsuccessful.

[14] Company Directors Disqualification Act 1986, s 6. See also s 8, which provides a discretionary means of disqualification which does not rely on the company having become insolvent.

[15] Mithani (ed), *Directors' Disqualification* (February 2015) p 656; *Re Bath Glass Ltd* [1988] BCLC 329, 333.

[16] *Secretary of State for Trade and Industry v Creegan* [2001] EWCA Civ 1742, [2004] BCC 835.

[17] Consultation Paper, para 4.37. Further discussion of disqualifications, including concerning directors of the insolvent companies we investigated, can be found between paras 4.40 and 4.58 of the Consultation Paper.

[18] 'Insolvency Service disqualifies 390 directors in first quarter', *Economia* (13 May 2016). Available here.

[19] Above and 'Bans for 'dodgy directors' at their highest for six years', *The Times* (13 May 2016).

B.37 Under the previous law, disqualification proceedings did not result in compensation to consumers. However, as discussed below, the 2015 Act allows the Secretary of State to pursue disqualified directors for compensation orders for the benefit of specific creditors or classes of creditors, or as a general contribution to the assets of the company.[20]

Small Business, Enterprise and Employment Act 2015

B.38 The Small Business, Enterprise and Employment Act 2015 (the 2015 Act) made numerous amendments to the Company Directors Disqualification Act 1986. In the Bill's second reading, the Secretary of State said that these were intended to "modernise and strengthen the disqualification regime, giving the business community and consumers confidence that wrongdoers will be barred as directors".[21]

B.39 In disqualification proceedings, the Secretary of State must now take into account behaviour of the director which occurred overseas when individuals have been directors of companies abroad. The Secretary of State must also consider evidence of the frequency of certain conduct when the director was involved with other companies.[22] This is targeted particularly at directors of "phoenix companies, which deliberately fail in order to be reborn and exploit consumers."[23]

B.40 The list of matters which the Secretary of State must consider when making a determination about disqualification has been amended. It is now in broader terms, for example referring to the extent to which the director was responsible for material contraventions by the company of legislation, rather than listing particular statutory duties.[24] Under the amended provisions, the Secretary of State must also consider the:

> nature and extent of any loss or harm caused, or any potential loss or harm which could have been caused, by the person's conduct in relation to a company or overseas company.[25]

B.41 However, the 2015 Act deleted the specific requirements to consider:

> the extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for (in whole or in part).[26]

[20] Small Business, Enterprise and Employment Act, s 110, providing for a new s 15A in the Company Directors Disqualification Act 1986.

[21] Second Reading of Small Business, Enterprise and Employment Bill 2014-15, House of Commons, 16 July 2014, col 913. Transcript available here.

[22] Company Directors Disqualification Act 1986, sch 1, paras 3 and 7.

[23] Second Reading of Small Business, Enterprise and Employment Bill, House of Commons, 16 July 2014, col 913.

[24] Company Directors Disqualification Act 1986, sch 1, paras 1 and 6. The legislation still refers to any misfeasance or breach of fiduciary duty by the director and the extent to which the director was responsible for the causes of a company becoming insolvent.

[25] Sch 1, para 4.

[26] Previously para 7 of sch 1 to the Company Directors Disqualification Act 1986.

B.42 Loss to prepaying consumers is now a general consideration rather than being referred to specifically.

Compensation orders

B.43 The 2015 Act also provides a power for the Secretary of State to make a compensation order against a director.[27] This power can be used where the Secretary of State is satisfied:

(1) that the person is subject to a disqualification order or disqualification undertaking, and

(2) that their conduct has caused loss to one or more creditors of an insolvent company of which the person was a director.

B.44 The Secretary of State's power is not linked to a fraudulent or wrongful trading action, nor directly requires proof that the director has misapplied funds. It can therefore have a much more general application.

B.45 Importantly for prepaying consumers, the newly introduced compensation orders may require the disqualified director to pay a specified sum to the Secretary of State:

(1) for the benefit of a particular creditor(s) or class(es) of creditors; or

(2) as a contribution to the assets of the company.[28]

B.46 In determining the amount, the court (in the case of an order) and the Secretary of State (in the case of an undertaking) must have regard to:

(1) the amount of loss caused;

(2) the nature of the director's conduct which has caused the loss; and

(3) whether the person has made any other financial contribution in recompense for it.[29]

B.47 This means that where a director's decision to continue taking prepayments has impacted particularly severely on consumers, any compensation received can be used specifically for the benefit of those consumer creditors. However, any contribution will be limited by the personal funds of the director.

[27] Alternatively, the Secretary of State may accept a "compensation undertaking" from the relevant director instead of applying for a compensation order (s 15A(2) of the Company Directors Disqualification Act 1986). This is an undertaking to pay an amount specified in the undertaking to the Secretary of State for the benefit of a creditor or class of creditors as a contribution to the assets of the relevant company (s 15B(2) of that Act).

[28] Company Directors Disqualification Act 1986, s 15B(1).

[29] Company Directors Disqualification Act 1986, s 15B(3).

B.48 These provisions have only been in force since May 2015. The intention was to increase the likelihood of directors being held financially accountable for their actions and to provide better redress for creditors who have suffered.[30] It is too early to tell what effect this will have in practice.

Case law

B.49 Generally, it appears that successful actions against directors are far more likely where the directors have acted for personal gain. It appears rare for directors to be disqualified where they simply made an error of judgement.

B.50 As we discuss below, disqualification proceedings were brought against the directors of World of Leather and Farepak. The former were unsuccessful and the latter were abandoned.

World of Leather and Uno

B.51 The Secretary of State brought disqualification proceedings against five directors of the now defunct furniture retailers World of Leather and Uno (its parent company).[31]

B.52 These companies had relied heavily on consumer deposits as a source of working capital and from November 1999 to March 2000 faced acute financial difficulties. During this period, deposits received increased from £2.1 million to £2.4 million and Uno accepted 100% deposits. On the advice of lawyers and accountants, the directors did not ring-fence or otherwise segregate this money as it came in: doing so would have caused the company to enter administration immediately. Instead, the deposits became part of the company's general assets.

B.53 The directors attempted to find a "corporate solution" but were ultimately unsuccessful. In March 2000, the company entered administration, resulting in customers losing deposits and not receiving the goods ordered.

B.54 The court dismissed the Secretary of State's disqualification proceedings and found that the directors had, at all material times, reasonable grounds for believing that insolvent liquidation could be avoided. The defendants' conduct in accepting the payment of deposits in order to continue searching for a corporate solution had not crossed the threshold of unfitness.

B.55 The court found that the directors had tried hard to find a solution, including considering a possible management buy-out or a sale to one of the company's suppliers. They had also taken advice from lawyers and accountants, kept their main creditors and suppliers informed and reviewed the situation regularly.

[30] BIS Impact Assessment: Giving the court and Secretary of State a power to make a compensatory award against a director (June 2014). Available here.

[31] *Re Uno plc & World of Leather plc* [2004] EWHC 933 (Ch), [2006] BCC 725. Two other directors had given voluntary disqualification undertakings.

B.56 Mr Justice Blackburne noted that, had a solution been found, a "satisfactory outcome for all the group's creditors, including not least its cash-paying customers" would have been made possible by continued trading.[32] He found that the directors had "gone out of their way to pursue a solution" and concluded:

> In my judgment, and notwithstanding the understandable anger of the cash-paying customers, it would be an injustice to brand the defendants' conduct over this period as meriting disqualification.[33]

Farepak

B.57 At the time of its collapse, Farepak owed consumers some £37 million. Clearly, these deposits had built up over the year. If administrators had been appointed earlier, consumers would have lost less.

B.58 Again, the Secretary of State sought disqualification orders against the directors of Farepak.[34] The Secretary of State was unable to present a positive case that liquidation was inevitable prior to October 2006 when administrators were appointed. Instead, his central contention was that the directors had done "too little, too late". He argued that they should have pursued the various solutions in parallel and that their actions in attempting to achieve a solvent solution were so unacceptable that they were unfit to be directors.

B.59 However, on legal advice and in the public interest, the decision was later taken to discontinue these proceedings. As we discuss in Chapter 8, the judge, Mr Justice Peter Smith, criticised the actions of the company's banks, but not those of its directors.[35]

B.60 The judge noted that the directors had "received a huge amount of criticism over their conduct", with savers believing that "the directors were responsible for their losses".[36] He thought these criticisms were misguided. Instead, he found that the directors had made "genuine strenuous efforts" to save the group. Additionally, the directors had asked the bank on at least two occasions whether Farepak could protect future deposits (by holding them on trust) or stop taking deposits altogether. Both these proposals were refused by the bank, meaning the directors "were in effect obliged to continue to receive the deposits and pay them over for the bank".[37]

B.61 Despite the judge's comments exculpating the directors, Deborah Harvey, co-founder of the Farepak Victims' Committee was reported as stating: [38]

[32] Above at [157].

[33] Above at [165].

[34] *Secretary of State v Fowler and others* (2012). As the proceedings were abandoned, this case was not reported.

[35] Judge's statement available online here.

[36] Above, para 19.

[37] Above, para 26.

[38] 'Slightly more Farepak: Victims of collapsed savings club win £8m in compensation', *Mirror* (6 July 2012). Available here.

> But I am still angry that directors who were behind the company have got away scot free.

And of the £8.2 million in fees drawn by the administrator:[39]

> The directors/owners of [European Home Retail – Farepak's parent company]/Farepak should be paying for that. We have had our cash taken, they messed the business up and to add insult to injury we have to pay to sort their mess out. How the hell can that be right?

B.62 In Chapter 8, we recommend a limited change to the order of payments to creditors on insolvency in order to mitigate the extent to which prepayments taken by a company in financial difficulty would benefit the floating charge holders.

Other cases

B.63 Further case law on directors' liability for accepting consumer prepayments prior to insolvency is rare and cases are generally unreported. However, we are aware of two cases involving lost deposits where directors gave voluntary disqualification undertakings (which have the same effect as a disqualification order but do not involve the court).

B.64 The Insolvency Service announced on its website that two directors of Chevron Lifts Ltd, a lift engineering firm in Northampton, were disqualified for seven years for "accepting a deposit [of £11,471] when they ought to have known there were no reasonable grounds for believing they would be able to provide the goods".[40] However, it was emphasised that:

> there were many other elements which may have characterised the directors' unfitness in this case, such as entering into transactions for their own benefit.

B.65 The Insolvency Service also announced a five-year disqualification of the two directors of Manor Furniture (Swindon) Ltd for:[41]

> putting customers' funds at unreasonable risk by accepting deposits when they ought to have known there were no reasonable grounds for believing they would be able to provide the goods.

B.66 The first director had taken £59,735 in the last months of trading, and the second director £40,614. Both directors in this case gave disqualification undertakings.

[39] 'Farepak victims to get compensation of £8m', *Guardian* (6 July 2012). Available here.

[40] https://www.gov.uk/government/news/lift-installers-get-7-year-bans-for-accepting-customer-deposits-when-company-was-insolvent.

[41] https://www.gov.uk/government/news/furniture-retailers-get-5-year-bans-for-accepting-deposits-and-failing-to-deliver-goods.

Conclusion

B.67 There will often be a peculiarly fine line between responsible attempts to keep a company going and desperate attempts to assuage secured creditors by taking in as much cash as possible before declaring insolvency. Creditors who are about to lose money will tend to focus narrowly on getting "their money" back, often at the expense of other creditors, and may be quick to assign blame.

B.68 It is right that the law allows for disqualification of directors, and for findings of wrongful or fraudulent trading. The Government has made some recent changes to the law on director disqualification and it will be interesting to see how they affect the numbers of directors being disqualified. There may be a case for revisiting the provisions on wrongful and fraudulent trading, and on directors' duties towards creditors more generally, in the future.

APPENDIX C
OPTIONS NOT PURSUED

C.1 In this appendix we discuss some of the proposals from the Consultation Paper which we have decided not to pursue, either because they were not well supported or because of we have identified alternative courses which we believe are more suitable. First we look at possible forms of regulation for the Christmas savings club market which we considered and rejected. We then explain why we have not pursued our attempts to make voluntary protection of prepayments easier. Finally, we explain why we no longer consider that the gift voucher intermediary market should be a particular target for regulation.

FORM OF REGULATION FOR CHRISTMAS AND SIMILAR SAVINGS SCHEMES

C.2 In Chapter 5, we make a case for requiring protection of consumer prepayments taken by operators of Farepak-style Christmas and similar savings schemes. In discussing the form which such regulation would take, we explain that we considered and rejected two possible forms of regulation in favour of the power to make secondary legislation discussed in Chapter 6. Below, we discuss the rejected options.

The Consumer Protection from Unfair Trading Regulations 2008

C.3 In the Consultation Paper, we suggested that marketing such a scheme without protecting consumer prepayments should constitute a form of misleading action or omission under the Consumer Protection from Unfair Trading Regulations 2008. The 2008 Regulations implement the 2005 Unfair Commercial Practices Directive.[1] An offence under the Regulations is punishable by fine or imprisonment of up to two years.

C.4 It is arguable that offering a "savings" product without protecting consumers' funds would already constitute a misleading action[2] or omission[3] if it would affect an average consumer's "transactional decisions" in respect of the product. However, this is by no means clear and could not be relied upon.

[1] Directive 2005/29/EC of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market, 2005 OJ L 149 22-39.

[2] Reg 5, implementing Art 6 of the Directive. This applies where the overall presentation of the product in any way is likely to deceive the average consumer.

[3] Reg 6, implementing Art 7 of the Directive. This applies to the omission of material information.

C.5 The Regulations also include a blacklist of practices which are always unfair,[4] to which we hoped unprotected savings schemes could be added. However, the Directive is a full harmonisation measure, meaning that member states cannot adopt measures that impose higher standards of consumer protection than the Directive.[5] Financial services were carved out of full harmonisation, allowing member states to impose more prescriptive requirements in these sectors, but it is doubtful that the definition of financial services in the Directive[6] would cover savings schemes.

C.6 In part because of the limitations of maximum harmonisation it seems that the 2008 Regulations do not provide a route for requiring protection of prepayments in this industry. In any case, as we discuss in Chapter 6, we consider that the Government should have a general power to require sector specific prepayment protection and think that savings schemes should be the first use of that power.

The prepaid funeral model

C.7 We continue to feel that designating "savings" schemes as deposit-takers, therefore bringing them within the regulatory remit of the Prudential Regulation Authority, would be disproportionate given the extent of the regulation to which banks and other financial institutions are subject. However, following consultees' suggestions that savings schemes should be treated as financial products, we considered whether there was an "intermediate" level of regulation for financial services. We looked at the model for regulation of prepaid funeral plans.

C.8 We considered whether the operation of a "savings" scheme should be made a regulated activity under the Financial Services and Markets Act 2000, subject to an exemption where the monies taken from consumers were adequately protected.

C.9 Compared to Christmas and similar savings schemes, prepaid funeral plans are likely to involve individual consumers paying larger sums of money, potentially held for a much longer period of time. There is therefore still an argument that, despite the vulnerability of the savers and their need to be protected, involving FCA regulation would be a disproportionate intervention. In particular, it would place additional burdens on the FCA in terms of identifying providers and monitoring whether providers were complying with the exemption or whether they should be investigated for carrying out a regulated activity without authorisation – and it would require the development of a body akin to the Funeral Planning Authority to assist the FCA with this monitoring.

[4] Schedule 1 of the Regulations, implementing Annex 1 of the Directive.

[5] Joined Cases C-261/07 and C-299/07 *VTB-VAB NB v Total Belgium* and *Galatea BVBA v Sanoma Magazines Belgium NV* [2009] ECR I – 2949. This position could of course change depending on the outcome of EU negotiations.

[6] Defined as "any service of a banking, credit, insurance, personal pension, investment or payment nature", in accordance with Directive 2002/65/EC.

C.10 Another concern is the subjective nature of our proposed definition of "savings schemes", based on consumer protection rather than a functional description of the nature of the product. This is somewhat at odds with the general style of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 and therefore the scope of the FCA's remit.

C.11 It is also worth pointing out that FCA regulation does not necessarily come hand in hand with access to the protection of the Financial Services Compensation Scheme. This would require an additional levy to be paid by providers which would be unlikely to be sustainable for the few savings club retailers who might be subject to FCA regulation.

C.12 Ultimately, we do not consider that the complications of FCA regulation would afford consumers sufficient additional protection as to justify this option. We think there is a more straightforward and effective way of regulating savings schemes, and other high-risk sectors which are identified in future.

Conclusion on regulation of Christmas and similar savings schemes

C.13 In Chapter 6, we recommend that the Government should have a power to require protection of consumer prepayments in sectors which pose a particular risk to consumers. We would recommend that this power is used to regulate savings schemes for the protection of prepaying consumers.

WAYS TO MAKE VOLUNTARY PROTECTION LESS ONEROUS

C.14 The difficulties and costs associated with protecting prepayments will often dissuade businesses from putting voluntary protection measures in place. In Chapter 10 of the Consultation Paper we considered ways to make voluntary protection less onerous for the businesses involved. We discussed ways to make trusts simpler and more affordable and asked how to increase the availability, and reduce the costs, of insurance. We also raised the possibility of a new consumer charge.

C.15 We report consultees' feedback on these issues below. Disappointingly, only a few people thought that our suggestions would help. Most respondents argued that the costs and difficulties were inherent in the nature of the protection and could not be mitigated. Given the responses we received, we are no longer pursuing this line of enquiry.[7]

Can trusts be made less burdensome?

Holding a proportion of funds on trust

C.16 It may not be feasible for a business to hold all prepayments on trust. We therefore asked consultees if trusts designed to protect some rather than all prepayments would be an acceptable compromise in some circumstances.

[7] See also Chs 3 and 6, for more about the difficulties of prepayment protection.

C.17 We pointed out that often consumers simply want the contracted goods or service, rather than their money back. It may therefore be acceptable to establish trusts designed to allow the provision of the goods or services. We gave the example of a gift voucher intermediary providing experience days, where £60 of every £100 received is used to pay the suppliers and the remaining £40 is used for the intermediary's own overheads and profit. If that £60 (rather than the full £100) were held on trust and the intermediary became insolvent, there may be sufficient funds for the administrator to pay third party suppliers and fulfil the customer orders.

C.18 Only a very few respondents were in favour of partial trusts.[8]

C.19 The proposal received backing from one voucher intermediary, Acorne plc, who said:

> Partial protection, especially of low-value high-volume payments must be better than no protection, providing the terms are made clear to the consumer.

C.20 However, consumer groups opposed the proposal, arguing that trusts which protected only a proportion of prepayments could lead to confusion. It would also encourage low standards. Jessica Morden MP said:

> It might leave an avenue for some businesses, if not the majority to persuasively argue that in their case it is neither practical nor affordable to ring-fence prepayments.

C.21 Other consultees were concerned about how such a system would work more generally: how it would be decided what proportion of a prepayment would have to be held on trust, and how a business would be able to demonstrate that it would not be practical or affordable to hold all of the funds in trust. Insolvency practitioners thought it would be difficult to reliably create and police a partial trust.

Standardised trust deeds

C.22 To address the cost and complexity of establishing a trust, we asked if it would be useful to develop a standard trust deed which businesses could adopt on a voluntary basis. This proposal was more popular, but it was still supported by fewer than half of respondents.[9]

C.23 Some respondents concluded that standardised trust deeds would be beneficial in bolstering the protections afforded to consumers. However, only KMPG expressly stated that standardised deeds could reduce legal costs.

C.24 By contrast, most respondents thought that trust law is too complex to allow for standardised terms. R3's Scottish Technical Committee said:

[8] We received 29 responses to this question. Six respondents (21%) were in favour of partial trusts. Fourteen (48%) were against them and nine (31%) marked "other".

[9] Of the 27 respondents who answered this question, twelve (44%) were in favour. Seven (26%) were against it and eight (30%) marked "other".

> The position is complex, trust law is different in the various jurisdictions of the UK and no trust deed could potentially cover all situations.

C.25 Similarly, Park Group plc said:

> The trust deeds would need to be flexible because each business will operate differently and it may not be appropriate to operate in the specific way contained in the standard trust deed.

C.26 The Competition and Markets Authority thought that the problems associated with trusts were fundamental, and could not be cured by the suggestions we had made:

> The experience of the OFT strongly suggests that it is in practice difficult to satisfy both the desire of businesses to be able to use pre-payments for commercial purposes and the interest of consumers in their being protected in the event of insolvency.

Conclusion on trusts

C.27 Given the responses we received we are no longer pursuing these proposals.

Encouraging insurance

C.28 In the Consultation Paper we saw potential in insurance as a means of protecting consumer deposits. We asked consultees to share their experiences of prepayment insurance with us, looking particularly at costs and the claims process. We also asked what could be done to overcome the problems of lack of data. We received 20 responses to the first question and 21 to the second.

Barriers to insurance

C.29 Chimera thought that our Consultation Paper discussion had been too negative:

> There is an existing market, there is claims experience and capacity will move into the sector if there is a need.

C.30 The ABI thought that that the main problem was lack of demand:

> Ultimately, consumers do not feel they are likely to lose out as the chance of insolvency is deemed very low, and if they do, the value of any loss is so low as to negate any demand for insurance or some form of protection.

C.31 We were told that insurers provide insurance for prepayments in the double glazing industry, where installers register with insurers and consumers are protected almost automatically.[10]

[10] See discussion at para 3.24.

Cost of insurance

C.32 Several organisations told us that the cost of insurance need not be prohibitive. In the double glazing industry FENSA and CERTASS told us that insurance for an installation would range from £15 to £25. FENSA said the insurance their members typically used would provide protection up to £25,000.

C.33 Gift voucher providers, however, were more negative about the cost of insurance. On insolvency, gift vouchers are likely to give rise to very large numbers of small claims and the potential cost of administering these claims could prove prohibitive. It was pointed out that consumers do not want to pay more than the face value of the voucher for this protection. Likewise, businesses do not want to absorb the cost of insurance within their margins, especially given that the gift voucher sector has a tendency to be a high-volume, low-margin market.

C.34 Many consultees pointed out that, one way or another, consumers would bear the cost of insurance. As the ABI put it:

> We would expect the cost of insurance to ultimately be borne by the customer, either indirectly through a higher cost of any products purchased, or directly through an insurance premium that is paid.

C.35 It was suggested that insurance could effectively become another “tax” on consumers. R3’s Scottish Technical Committee said:

> If retailers pass the cost to the consumer by increasing prices (and if the policy is aimed at “the most vulnerable“) the price may then become unaffordable.

Conclusion on insurance

C.36 Insurance is a viable method of protecting consumer prepayments if there is sufficient demand. However, insurers may view any single retailer seeking insurance with some suspicion. These problems may be overcome if many retailers act together to request insurance arrangements.

C.37 One advantage of regulation (or at least the threat of regulation) is that it might promote such collective action. We hope that more insurance products will be developed if and when the power to make sector specific regulation, discussed in Chapter 6, were used.

A new “consumer charge”?

The proposal

C.38 In the Consultation Paper we proposed a possible alternative to trusts and insurance. We suggested setting up a new statutory scheme to allow retailers to register a voluntary “consumer charge” at Companies House.

C.39 This was intended as a direct alternative to setting up a trust. Like a trust, it would be a voluntary action by a business while it was still trading. But unlike a trust it would enable the business to use consumer funds as working capital.

C.40 The charge would give specified consumer debts preferential status on insolvency. It would effectively be a first-ranking floating charge, which would rank below fixed chargFes and the rights of preferential creditors but above other floating charges. It would therefore need consent from any existing floating charge holder, but would be clearly visible to any subsequent floating charge holder. It could be used for all consumer prepayments or only some (such as a charge in favour of those participating in a Christmas savings scheme).

C.41 There would be one-off costs of registering, but once registration was complete, the business would incur no further costs. We thought it would therefore be cheaper than the continuing costs of running a trust. We asked if there was any merit in developing this idea.

Consultees' views

C.42 Only a third of respondents to this question were in favour of the possible development of a consumer charge.[11]

C.43 Several insolvency practitioners opposed the proposal as contrary to the principle of treating all creditors equally, which was described as "ingrained within insolvency legislation". More practically, the proposed "consumer charge" would need the consent of existing floating charge holders and several respondents thought that this was unlikely to be obtained. As Professor Sheehan put it, "turkeys tend not to vote for Christmas".

C.44 Insolvency practitioners raised concerns about how the proposal would impact on the cost and availability of finance. Many thought that it would also increase the time and cost of dealing with an insolvency.

C.45 In the Consultation Paper we noted that the idea of a consumer charge would require further policy development and statutory reform. We do not think that the weak support for a consumer charge justifies the complex work it would entail.

GIFT VOUCHER INTERMEDIARIES

C.46 In the Consultation Paper we expressed concern about voucher schemes where funds were held by an intermediary until the voucher was used. We proposed that the Government should have a reserve power to require protection of prepayments in this sector. Below, we explain why we do not pursue this proposal. Instead, in Chapter 6,[12] we recommend a more general power which would allow the Government to require prepayment protection in any sector where the risk to consumer prepayments justifies it.

C.47 Examples included limited network cards, which could be redeemed against a wide range of retailers but for a limited category of goods. Well-known examples are book tokens, theatre tokens and spa vouchers. Other intermediary models are those which sell vouchers for "experience days" such as hot air balloon rides, or websites such as Groupon and Wowcher which advertise a wide range of discounted goods and services.

[11] We received 32 responses to this question. Eight respondents (25%) were in favour; 18 (56%) were against it and 6 (19%) marked "other".

[12] Particularly from para 6.25.

C.48 In all these cases, the funds are held by an intermediary until the voucher is used. On the intermediary's insolvency, the retailer or other third party supplier will not get paid, and are therefore likely to refuse to honour the voucher. As intermediaries do not hold stock, they are less likely to trade while in administration. They are also less likely to involve well-known brands which administrators and future purchasers will wish to preserve by accepting vouchers.

C.49 Clearly, not all voucher intermediaries are high-risk, but they may become so if they hold significant sums for a relatively long time, and do not take any steps to protect the funds.

C.50 We noted that well-established schemes which are run on a not-for-profit basis (such as National Book Tokens, Theatre Tokens and National Garden Gift Vouchers) already hold funds to pay suppliers in low-risk investments, while adhering to rigorous accounting standards.

C.51 However, there is nothing to stop a firm from setting up as an intermediary, selling vouchers to be used several months later, and using the funds it receives for a different venture. Intermediaries are under no obligation to segregate the funds they receive from consumers. Instead they may use the funds for any purpose, including buying another business, lending money to another member of the group, or expanding the business through advertising.

C.52 So far this sector has not caused significant losses to consumers. The only major insolvency in this sector was Red Letter Days, a gift voucher intermediary selling experience days. It entered administration in 2005 with around 140,000 vouchers outstanding, having failed to retain funds to pay suppliers.[13] In that case, losses to consumers were avoided when the purchasers of the business agreed to honour outstanding vouchers.

C.53 However, we thought that the Government should be able to act quickly and proactively when a particular risk is identified. In the Consultation Paper we proposed legislation to provide the Government with reserve powers to regulate high-risk voucher intermediaries which hold significant funds over a long period and which may use those funds for other purposes without providing consumers with protection.

Consultees' views

C.54 Less than half of consultees were in favour of the proposal.[14]

C.55 Consumer groups were generally supportive, citing the lack of protection afforded to prepaying consumers and questioning the propriety of a business continuing to accept prepayments when there is little chance of them being honoured.

[13] Red Letter Days, *Statement of administrator's proposals* (September 2005) para 13.1.

[14] Eleven (46%) of the 24 respondents who answered this question were in favour; four (17%) were against it and nine (38%) marked "other".

C.56 However, two sorts of arguments were put against proposals. First, the gift voucher industry said that we were wrong to single out voucher intermediaries: they were no higher a risk than many businesses, and regulation would impose undue costs. Second, it was argued that if there was a need to regulate, we should do so directly rather than simply give Government the power to regulate at some future date.

Concerns from gift voucher intermediaries

C.57 Gift voucher intermediaries objected to being labelled as "high-risk". For example, Book Tokens Ltd said:

> We do not recognise the term "high-risk voucher intermediaries" and, as we have stated clearly in the past, have not seen any evidence to support this potentially damning categorisation.

C.58 The UK Gift Card and Voucher Association said that intermediaries are already under commercial pressure to operate on a sound financial basis, suggesting that they would be foolish to undertake high-risk practices:

> It should also be borne in mind that intermediaries will be subject to commercial and financial scrutiny by those businesses (retailers) that it works with, because the retailers have an interest in protecting their brand and reputation from being adversely impacted by the acts or omissions of a party with whom it works.

C.59 There were also objections to the high cost of regulation. Book Tokens said:

> Voucher intermediaries tend to work on very tight margins – the cost of unnecessary protection could easily be insolvency, even for established businesses.

C.60 The Society of London Theatre expressed similar thoughts:

> Any protection mechanism brings with it enhanced costs and for Theatre Tokens, a not-for-profit organisation operating a low margin business model in order to support the theatre industry, these are likely to have a significant impact on the activity possibly resulting in its demise.

Conclusion

C.61 We accept that the case for targeting voucher intermediaries has not been made out. As we discuss in Chapter 6, we think there is a case for a regulation making power to allow for regulation of prepayments in sectors where the case is made out.

APPENDIX D
ASSESSING THE IMPACT

D.1 Several of our recommendations would require legislation or other regulation to implement. In this appendix, we summarise where we think the main impacts of those recommendations would be felt. Of course, before any of these recommendations were implemented, it would require a full impact assessment where the costs and benefits are costed.

PROTECTION OF CONSUMER FUNDS BY "SAVINGS" SCHEMES

D.2 In Chapter 5 we recommended regulation of schemes which take consumer prepayments in return for goods, services, or vouchers; and which are either

(1) marketed as being suitable as a savings mechanism; or

(2) would be understood by "an average consumer" as being a form of savings.

D.3 In Chapter 6, we recommend that the Government should have a power to require protection of consumer prepayments in sectors where intervention is justified. We think that regulation of savings schemes should be effected through this mechanism. The protection – which could be by trust, insurance or bonding – should be sufficient to ensure that the promised goods, services and vouchers can be provided.

Who would be affected?

D.4 Three types of scheme would be affected by this change:

(1) The six members of the Christmas Payment Association. These businesses have already agreed to protect prepayments, so there would not be significant change. However, they would have to familiarise themselves with the regulations and check the details of their trust arrangement to ensure compliance.

(2) Supermarkets who run Christmas clubs. Several – but not all – place money in trust. Others segregate payments in a dedicated bank account (even though this would be ineffective on insolvency). Again, these schemes would need to familiarise themselves with the new arrangements. Supermarkets which had not already declared a trust over the money would need to do so.

(3) All gift voucher issuers would need to be aware that vouchers should not be marketed as a form of savings if the payments are not protected. Some voucher providers would need to change their marketing material: we envisage that the costs of the change would be low, provided that businesses were given sufficient notice of the change.

Costs

To businesses

D.5 The main costs would be the legal and administrative costs of putting the protections in place, and maintaining them.

D.6 In terms of trusts, this would include reviewing and drafting trust deeds. The cost of trust deeds would be reduced if industry bodies worked together to produce standard documentation.

D.7 A few schemes may currently use consumer funds as working capital or to fund other investments. These businesses would need to hold trust funds in interest-paying bank accounts or in other low-risk investment, which will yield some income but not as much as if the money was put at greater risk.

D.8 It may be that insurance is a preferable option, as it does not deprive the business of access to the prepayments as working capital. If regulation was introduced so that a number of scheme providers were seeking insurance, we think that a market would emerge to provide the necessary insurance at reasonable cost.

To enforcers

D.9 As we discuss in Chapters 5 and 6, we think that Trading Standards must be the primary enforcer of any regulations in respect of savings schemes. We think there are a relatively small number of schemes in operation, but clearly this would put some additional burden on Trading Standards which must be recognised.

D.10 In Chapter 5, we note that trade bodies often play a valuable role in enforcement of obligations to protect prepayments – notably ABTA in the travel industry and the Funeral Planning Association in respect of prepaid funerals. For savings schemes, we think that the Christmas Prepayment Association already performs this role to some extent and would be in a good position to not only monitor compliance by its own members but also identify similar schemes run by non-members. We hope that the additional costs to the CPA would not be significant.

Benefits

D.11 The main benefits would accrue to consumers, who would no longer be at risk of losing their savings. There may also be an improvement for businesses running savings schemes, as consumer confidence would be increased.

D.12 Without regulation, there is the risk of a repeat of the Farepak collapse, leading to loss of confidence in Christmas savings schemes and calls on the Government and banks to provide a hardship fund. Preventing this scenario therefore represents a benefit to business, by maintaining confidence and avoiding the need to make payments to a hardship fund.

PREFERENTIAL STATUS FOR A SMALL NUMBER OF CONSUMER CLAIMS

D.13 In Chapter 8 we recommended that, if the Government wishes to improve the position of the prepaying consumers in the event of retailer insolvency, it should consider giving preferential status to a limited category of consumer claims. The claim would have preferential status it if met **all** the following criteria:

(1) The **claimant is a consumer** as defined in section 2(3) of the Consumer Rights Act 2015.

(2) The claim relates to a **prepayment**. In other words, the consumer has paid money to the insolvent business (or has parted with goods with a money value), and did not receive goods or services in exchange.

(3) The consumer has paid **£250** or more during the **six months** immediately prior to the insolvency, either in a single transaction or in a series of linked transactions.

(4) The consumer used a payment method (such as cash or cheque) which was **not protected through chargeback**; and the prepayment was not protected in any other way.

Who would be affected?

D.14 It is now rare for consumers to pay sums of over £250 by cash or cheque, so this recommendation is unlikely to affect the great majority of retailers. However, the market for payment services is evolving rapidly, and some new "account to account" payment methods do not provide the same insolvency protection as debit and credit cards.

D.15 One of the main arguments for this recommendation is that it would apply generally, including in new and unexpected areas, as both the retail market and payment services market evolve. It is therefore not possible to predict exactly who would be affected. Here we provide a brief discussion of how it may apply in the sectors we have considered.

Furniture and home improvement sector

D.16 In the past, the insolvency of retailers in this sector has led to significant consumer losses. For example, when MFI entered administration in 2008, consumers who had paid by cash and cheques were owed an estimated £8.5 million. These customers tended to come from lower socio-economic groups and, as the prescribed part was disapplied, they received no recompense.

D.17 Since 2008, there has been a substantial increase in card payments and a commensurate decrease in payments by cash and cheque. The effect would therefore be less. However, the rise of new payment techniques may reverse this trend in the future.

MORE CAUTIOUS LENDING?

D.18 We have considered whether banks and other lenders would be more cautious in their lending to this sector. We do not think there would be any effect for most retailers, who take the vast majority of large prepayments by debit or credit card, and where merchant acquirers already hold back collateral to cover chargeback claims. However, in the small minority of cases where retailers were known to take large sums by other methods, lenders would need to exercise greater caution. There would be particular red flags if a retailer faced with possible insolvency increased the number of large non-card prepayments it received from consumers.

D.19 Although in some circumstances this may make lenders less willing to lend, we also see economic benefits from this caution. There are serious doubts about whether directors should be continuing to trade if they are increasingly reliant on large cash payments from consumers.

COST AND DELAY ON LIQUIDATION?

D.20 Insolvency practitioners expressed concern that the recommendation would add cost and delay to the liquidation process.

D.21 We do not think those costs would be as great as insolvency practitioners feared. In many cases, preferential status would result in the consumer receiving the goods rather than getting a refund. We have been told that, where trading continues in administration and commercial considerations allow, administrators will try to fulfil orders. However, at present, they can only do so where the deposit is relatively small (so that the final payment covers the cost of supply and delivery), or where the merchant acquirer agrees to fund the fulfilment of orders because this will reduce their chargeback liability.

D.22 We think that one advantage of the limited preference is that it would allow orders in the pipeline to be delivered during a period of trading in administration in an orderly and cost-effective process, even where the consumer has paid a large deposit by cash or cheque.

D.23 This point can be illustrated with an example, in which the consumer has prepaid £1,000 by cheque for a sofa which it costs the retailer £500 to supply:

(5) Under the existing law, the consumer would have an unsecured claim of £1,000. It would be wrong for the administrator to deprive the general body of creditors of £500 in order to fulfil the order, thereby extinguishing the £1,000 claim.

(6) If, however, the consumer's claim of £1,000 was preferential, the administrator would be able to exercise commercial judgement on this issue. It would be cheaper to pay £500 to fulfil the order and extinguish the preferential claim, rather than repay £1,000 to the consumer.

D.24 We accept in some cases it may not be possible to deliver the goods, and it would be necessary to process the claims on liquidation. The recommendation would lead to two changes to the process.

(1) Floating charge holders could not be paid until the administrator had established the total value of preferential claims.

(2) At present in a few insolvencies (such as MFI), the prescribed part is disapplied and there are no funds following payment to floating charge holders. Therefore claims from cash-paying consumers are not processed at all. Under the recommendation, preferential claims from consumers would need to be processed, leading to administrative costs.

The gift voucher sector

D.25 We think that a consumer preference of this nature would have a limited impact on vouchers. Most vouchers have a face value of less than £250, and may well be held for more than six months. We accept that the protection given to voucher holders under this change would be limited, but hope that it would sit alongside voluntary protection.

D.26 As the UK Gift Card and Voucher Association said:

> With respect to the gift card and voucher market, this proposal is unlikely to apply since the majority of gift cards and vouchers purchased are for low amounts. Also, given the size of this market, it would be uneconomical for an administrator to identify each card or voucher holder and return the funds to them.

D.27 Of course, there may be cases in which a consumer has paid for a voucher of more than £250 in cash within six months before insolvency – and in these cases the consumer who made the purchase would have a preferential claim. The claim would have to be made by the purchaser rather than by the recipient and would depend on how the purchaser had paid for the voucher.

The energy sector

D.28 It is relatively common for consumers to build up surpluses with their gas or electricity provider. These arise for a variety of reasons: consumers may be asked for deposits, may over-pay during the summer and under-pay during winter due to the seasonal change in consumption, or may experience billing issues which lead to overpayments.[1] Many consumers may therefore have built up balances on their accounts prior to the insolvency of their energy provider.

D.29 Ofgem, the regulator for the gas and electricity markets, has powers to take action on insolvency of energy suppliers with the primary focus of ensuring the continuity of energy supply to consumers. They are also keeping the protection for consumer prepayments in this sector under review.

D.30 If the limited preference for consumers were introduced, this would apply to consumer customers of an insolvent energy company. Direct debit payments – the most common form of payment for utility bills[2] - are not covered by the chargeback scheme, so many consumers with large surpluses are likely to satisfy our proposed requirements.

D.31 It was put to us that where surpluses were built up over time it may be difficult to determine which payments fall within the six month limit. We think it may be necessary to provide rules about how the six month calculation should be made.

[1] According to research by USwitch in 2015, 12 million households were owed a total of £1.1 billion by energy suppliers – an average of £93 each. Over one in 10 were thought to be owed more than £200. http://www.uswitch.com/media-centre/2015/07/energy-suppliers-could-owe-1-1-billion-to-customers/.

[2] In December 2014, Ofgem said that over 55% of customers pay their energy bills by direct debit. https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/direct_debit_factsheet_jan_2015_english_web_2_0.pdf.

D.32 In our view, where the consumer has a surplus of more than £250, all payments up to the amount of the surplus made during the six months immediately before insolvency should be treated as linked transactions which contribute to the prepayment. This point can be illustrated with an example:

> In January a consumer makes a £200[3] deposit together with the monthly payment of £200. Each month thereafter they make a payment of £200. Their use of fuel varies:
>
> (a) In the colder months (January to March and October to December) the consumer uses £210 of fuel each month (£1,260 total).
>
> (b) In the remaining milder months, the consumer uses £170 of fuel each month (£1,020 total).
>
> At the end of December, the energy supplier becomes insolvent.
>
> By the time of the insolvency, the consumer has paid £2,600 and has used £2,280 worth of fuel. They are therefore owed £320.
>
> During the last six months (the relevant time period for prepayments under our recommendations) they have paid a total of £1,200 in linked transactions (6 x £200). They would therefore be entitled to make a preferential claim for the full £320 which is owed.

D.33 As with furniture retailers, the recommended change may make lenders more cautious, particularly if energy suppliers at risk of insolvency were to use direct debit to overbill consumers. Again, we think that this caution would be beneficial.

D.34 It may also add to the costs and delay of dealing with the insolvency. That said, we think that the insolvency of any major energy provider is likely to be difficult to resolve. We doubt that it would be possible politically to refuse to process large claims from individual consumers.

Costs

D.35 We accept that this recommendation would lead to costs to business, which would have to be estimated in any final impact assessment. The main impacts would be:

(1) The effect on the return for floating charge holders, and possible impact on cost of borrowing as a result. We do not consider that this impact would be as significant as some consultees suggested, because the number of consumers who would qualify for the limited preference would be low in the vast majority of cases.

(2) The impact on insolvency practitioners' work caused by having to assess and potentially pay consumer claims at an earlier stage in the process. The costs of this would need to be assessed.

[3] Anecdotal evidence suggests that, where an energy provider asks for a deposit, it is usually a month's payment.

D.36 We have also considered the impact on other unsecured creditors. In many cases the impact would be minimal. Where the business has secured creditors and, in particular, floating charge holders, our sample of high street insolvencies showed that the return to unsecured creditors is usually negligible or nil in any event. In the rarer cases where there are no secured creditors, the returns tend to be higher. These would be reduced if some consumers had already been paid as preferential creditors.

Benefits

D.37 The main benefits would accrue to consumers who had paid large sums by methods other than credit or debit card. These consumers are particularly likely to be economically vulnerable.

D.38 As with the regulation of saving schemes, the main benefits to business would lie in maintaining consumer confidence and avoiding the need to make payments to a hardship fund. We think that the political and social ramifications of an energy supplier insolvency would be particularly acute. If vulnerable consumers in fuel poverty were seen to lose large sums, there would be considerable pressure on floating charge holders and the Government to make good the loss.

TRANSFER OF OWNERSHIP

D.39 In Chapter 9 we recommended some relatively limited changes to the rules on transfer of ownership, to improve certainty for consumers, insolvency practitioners and shop staff. Although we have recommended a general change in all circumstances and not just on insolvency, in practice it is on insolvency that any reform would make a difference. This is because, in most other situations, the important issue is whether the goods are at the seller or the buyer's risk (in the case of loss or damage, for example), rather than where ownership lies. In consumer cases, risk does not pass to the consumer until delivery.

D.40 One cost of our recommended change to the transfer of ownership rules would be the cost of training insolvency practitioners to apply them. Discussions with insolvency practitioners and responses to our Consultation Paper suggested that there were differing interpretations of the current law. Training would be required to ensure a consistent application of the new rules.

D.41 Our main aim is to improve certainty because of the difficulty in applying the existing rules in a consumer context. However, our recommendations would also mean that, in some cases, ownership would be transferred to the consumer at a slightly earlier point.

D.42 In those circumstances, the goods would belong to the consumer rather than to the business. They would have to be made available to the consumer (subject to the consumer's paying any balance due) rather than being part of the business' property which could be re-sold. Earlier transfer of ownership would also have an impact on suppliers with retention of title claims, as those would be trumped if ownership had transferred to a consumer purchaser.