Law Commission
Reforming the law

Consumer Prepayments on Retailer Insolvency
A Consultation Paper

50 YEARS

Consultation Paper No 221

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CONSUMER PREPAYMENTS ON RETAILER INSOLVENCY

A Consultation Paper

THE LAW COMMISSION – HOW WE CONSULT

About the Commission: The Law Commission is the statutory independent body created by the Law Commissions Act 1965 to keep the law under review and to recommend reform where it is needed.

The Law Commissioners are: The Rt Hon Lord Justice Lloyd Jones (Chairman), Professor Elizabeth Cooke, Stephen Lewis, Professor David Ormerod QC and Nicholas Paines QC. The Chief Executive is Elaine Lorimer.

Topic of this consultation paper: Consumer prepayments on retailer insolvency.

Geographical scope: England and Wales.

Duration of the consultation: 18 June 2015 to 17 September 2015.

How to respond

We provide an optional response form on our website. Please send your responses either:

- **By email to**: prepayments@lawcommission.gsi.gov.uk or
- **By post to**: Laura Burgoyne, Law Commission, 1st Floor, Tower, Post Point 1.53, 52 Queen Anne's Gate, London SW1H 9AG
  Tel: 0203 334 5327

If you send your comments by post, it would be helpful if, where possible, you also send them to us electronically.

After the consultation: We plan to publish recommendations in 2016 and present them to the Government. It will be for Government and Parliament to decide whether to change the law.

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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.
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.
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").
Lien	A right to hold property belonging to another until a debt owed by them is paid.
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.
Pre-packaged administration or pre-pack	An administration where a buyer has been found for the company before it enters administration.
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.
Protective award	A sum paid to employees of a business who have been made redundant without being properly informed and consulted.
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
PTR	The Package Travel, Package Holidays and Package Tours Regulations 1992
TFO	The Furniture Ombudsman

ONLINE CONTENT

All websites and electronically available materials referenced in this document were last accessed on 9 June 2015.

CHAPTER 1
INTRODUCTION

1.1 Consumers often pay for goods and services in advance of receiving them. This is common practice for a range of products - from flights and theatre tickets to football season tickets and magazine subscriptions. Many furniture retailers rely on receiving deposits to place orders with suppliers. Holiday companies and hotels need the security of payment in advance to ensure consumers do not cancel at the last minute. In 2014, the gift card and voucher market in the United Kingdom was valued at £5.4 billion,[1] with consumers and businesses paying immediately for a card or voucher which will allow the holder to obtain an item at some stage in the future.

1.2 If the company that has taken the prepayment becomes insolvent, consumers risk losing their money. Insolvency law does not give consumers any special protection. Along with trade suppliers, landlords, HMRC and others, consumers are unsecured creditors who will not receive anything until secured creditors (such as 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 is a wide variety of ways in which consumers may be protected - through industry-specific schemes, through protections provided to those who pay with credit and debit cards, and through the commercial decisions taken by administrators. However, such protection is patchy and cannot always be relied on.

HIGH-PROFILE INSOLVENCES

1.4 Over the years, there have been many notable cases where consumers lost out or risked losing out. In 2006, consumers who had been saving for Christmas lost around £37 million when Farepak collapsed. Savers ended up receiving just under 50 pence in the pound from the liquidators and from a special indemnity fund set up for their benefit.

1.5 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 held by these companies in consumer prepayments was significant, and cash buyers lost substantial sums. For example, when MFI went into liquidation, it held over £27.3 million in deposits. Consumers who had paid in cash were left without a remedy and suffered losses of around £8.5 million.[2]

[1] UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf. This figure represents both business-to-business (B2B) and business-to-consumer (B2C) transactions. In recent years, sales of gift cards and vouchers are split almost evenly between those to consumers and those to businesses. We discuss this further in Chapter 7 at paras 7.10 to 7.13.

[2] As we discuss in Chapter 5, certain protections are available to those who pay by credit or debit card.

1.6 During the recent recession, high street chains such as Borders, Comet, HMV, Republic and Zavvi went into administration with many gift cards and vouchers in circulation. Trading continued in administration and uncertainty surrounded the question of gift voucher redemption. In many cases, administrators decided to allow consumers to redeem vouchers, but not always. Vouchers for Republic and Zavvi, for example, were not honoured.

1.7 The travel sector has always been particularly susceptible to financial failure. High-profile collapses in the 1970s led to protection through the ATOL scheme and the trade body ABTA.[3] While forms of protection are now in place, financial failure continues to be a feature of the travel landscape: a recent call for evidence from the Department for Transport highlighted four significant failures of travel operators between 2008 and 2013, costing a total of £130 million.[4]

1.8 This project was not motivated by any particular insolvency. Instead we take a more general and long-term look at the issue. We draw on many high-profile cases, but have also looked at a number of smaller businesses which have become insolvent owing money to consumers.

THIS PROJECT

Terms of reference

1.9 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.

[3] ATOL stands for Air Travel Operators Licence. ABTA was previously known as the Association of British Travel Agents. These schemes are explained from para 6.60 and in Appendix D.

[4] Department for Transport, *Review of Package Travel Directive and ATOL Implementation and Funding Arrangements: Call for Evidence* (May 2013).

1.10 We have not been asked to draft legislation. The aim of this consultation paper is rather to generate informed public debate about these issues and to identify possible solutions which the Government could take forward. Any proposals we make are purely provisional, and often we simply ask questions.

Geographical scope

1.11 This is not a joint project with the Scottish Law Commission and we make proposals only for England and Wales. However, as all the areas of law we consider – consumer law, banking law and the relevant parts of insolvency law – are reserved, we hope that the Government would be able to implement these proposals throughout the United Kingdom. Indeed, given that large retailers which operate in England and Wales also tend to have stores in Scotland and Northern Ireland, and that consumers would expect their rights to be consistent across the United Kingdom, we think that it would be difficult to have differing levels of protection in each jurisdiction.

Definitions and scope

Consumer

1.12 We are focussed on 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

1.13 This project is only concerned with prepayments – that is, payments made by consumers in advance of goods or service being provided. Consumers may pay fully in advance, pay a deposit or purchase a gift voucher for a friend or relative.[5]

1.14 In the great majority of cases, the prepayment will be in the form of money but we also include cases where consumers may have parted with goods with a monetary value (such as sending gold to a "cash for gold" firm). Game and Blockbuster, two retailers which entered administration in 2012 and 2013 respectively, ran trade-in programmes, allowing consumers to trade-in their old electronic games or DVDs for credit to be spent in store.

[5] Consumers may acquire gift vouchers in other ways, such as through a retailer's promotional scheme, through an employee incentive scheme, or as settlement of an insurance claim. We have been told it may be difficult to distinguish between these types of voucher, which do not involve a prepayment, and those that do. We address this issue in Chapter 7.

1.15 Of course, 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. We have not included these within the project. Nor have we considered extended warranties. Most extended warranties are provided by insurers or manufacturers: where retailers provide them, they are often more akin to a form of extended liability for faulty goods rather than a prepayment. It is true that in some circumstances a retailer's extended warranty may be considered a separate service for which the consumer has prepaid, but we think any concerns about warranties would need to be considered together, in a separate project.

1.16 We accept that when a business becomes insolvent, many creditors will lose out and it is not possible to protect all types of consumer claim. However, prepayments differ from other forms of consumer claim because they provide the trader with new money – the consumer is effectively making a loan to the firm which it can use as a source of working capital. This raises difficult questions about how far businesses should be entitled to rely on prepayments in this way, how far consumers are able to assess the insolvency risk of the firm to which they are "lending", and how far that new money should be segregated or repaid in preference to other creditors.

Retailers

1.17 In this project, we use the term "retailer" widely to cover all companies which provide goods and services to consumers (ranging from airlines and hotels to builders and Christmas clubs). However, much of the public's concern has centred on large retail chains. In Chapter 3, we analyse what happened to 20 such chains which have entered administration since 2008. We refer to these stores as "high street retailers", even though some were more likely to be sited out-of-town than on high streets.

1.18 Of course, it is not just large retailers who may become insolvent. In Chapter 3, we consider the outcome for consumers when smaller retailers experience financial problems. In Chapter 6, we analyse the protections in place in sectors where sole traders or local businesses tend to operate. Since almost all large and medium retailers and many small retailers trade as companies, rather than as individuals or as partnerships,[6] we deal only with the law affecting companies.

1.19 We have not been asked to consider money paid to financial institutions, such as banks or insurance companies. In some ways, a bank deposit is a prepayment: consumers entrust their money with a bank in the expectation that it will be returned. Consumers also prepay a premium for insurance cover in the expectation that payouts will be made if and when an insured event occurs. However, banks and other financial institutions are already heavily regulated, with complex schemes such as the Financial Services Compensation Scheme to protect consumers on insolvency. Those schemes are outside our terms of reference.

[6] Between March 2013 and March 2014, 94.13% 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, 2014*, dataset: UKBC - Enterprise/local units by Industry, Employment size band and Legal status, http://www.ons.gov.uk/ons/rel/bus-register/uk-business/2014/index.html.

Insolvency

1.20 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 may not be able to obtain stock to fulfil consumers' orders. Alternatively, the directors of the business may have sought to defraud customers by taking consumer prepayments with no intention of fulfilling the orders. This consultation paper is not intended to deal with these situations.[7]

1.21 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. We describe the main forms of insolvency procedure in Chapter 2. In all of the particular examples we consider in Chapter 3, the retailer was a company which went into administration and/or liquidation.

A LONG-STANDING PROBLEM

1.22 Concern about consumer prepayments is far from new. The issue has been considered many times, including by the Cork Report in 1982; by the now disbanded Office of Fair Trading (OFT) in 1984, 1986 and 2006; and by Consumer Focus in 2009.

1982: The Cork Report

1.23 The Insolvency Act 1986 was introduced following the report of the Review Committee on Insolvency Law and Practice, chaired by Sir Kenneth Cork.[8] It was a highly influential report which covered all aspects of insolvency law.

1.24 The Committee had received many complaints from members of the public who had paid in advance for goods and services and were left without a remedy on retailer insolvency.[9] 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 consumers and trade customers who pay in advance for goods or services to be supplied later: each gives credit, and the Committee considered that each should bear the same proportion of the loss.[10]

1.25 The Committee did not accept that businesses should be required to segregate consumer prepayments and hold them on trust for the benefit of consumers. It noted that firms could do this voluntarily, but in many cases "advance payments are an essential part of the trader's working capital".[11] One member of the Committee dissented, arguing that consumers "should not be expected to provide working capital".[12]

[7] However, as we discuss in Chapter 5, consumers who have paid by credit or debit card are able to ask their card issuer to reverse the transaction in these circumstances.

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

[9] Above, paras 1048 to 1056.

[10] Above, para 1052.

[11] Above, para 1050.

[12] Above, para 1053.

1.26 However, the Cork Committee did recommend that directors should be personally liable for wrongful trading.[13] They thought that this would be appropriate when directors took prepayments knowing that they might not be able to deliver the goods or services.[14] This recommendation was only partly taken forward. As discussed in Chapter 4, liability for wrongful trading provided for under the Insolvency Act 1986 is not nearly as extensive as the Cork Committee suggested it should be.

1984: OFT Discussion Paper

1.27 In a discussion paper of October 1984,[15] the OFT undertook a quantitative analysis of the prepayment market. It noted that while the total extent of loss was small in comparison with total consumer spending, losses could be significant for individuals.

1.28 The paper was sympathetic to businesses' need for consumer prepayments as a source of working capital. It therefore said that requiring trust arrangements for consumer prepayments would not be a workable solution across the board. The OFT thought that some form of insurance requirement or a requirement to obtain a bond[16] might be more feasible, but had no indication of their likely cost.[17]

1.29 The preferred approach was "the evolutionary development of schemes designed to cover particular problem areas". The paper said that these schemes would ideally be on a voluntary basis, but acknowledged that statutory powers would be required where voluntary action was not forthcoming.[18]

1.30 Unlike the Cork Committee, the OFT did not think that consumer and trade creditors should be treated alike. The paper argued that consumers had little information about the retailer's financial status. Consumers were assuming an insolvency risk on an uninformed basis and without their knowledge or consent.[19]

1986: OFT Report on the protection of consumer prepayments

1.31 Two years later, after the passage of the Insolvency Act 1986, the OFT issued a report outlining reactions to the 1984 Discussion Paper.[20]

[13] Above, chapter 44. Such an action did not exist at the time, though an action against directors for fraudulent trading was possible.

[14] Above, para 1056.

[15] Office of Fair Trading, *The Protection of Consumer Prepayments: A Discussion Paper* (October 1984). See also A Ogus and C Rowley for the Office of Fair Trading, *Prepayments and Insolvency* (October 1984).

[16] A bond is a guarantee under which the bond issuer, normally a bank or insurance company, undertakes to pay an agreed sum if a certain event – such as insolvency – occurs.

[17] Office of Fair Trading, *The Protection of Consumer Prepayments: A Discussion Paper* (October 1984) paras 7.6 and 7.7.

[18] Above, para 7.9.

[19] Above, para 7.4.

[20] Director General of Fair Trading, *The Protection of Consumer Prepayments* (March 1986).

1.32 The OFT expressed disappointment that the Insolvency Act did not do enough to help consumer creditors. The Act failed to give consumers preferential status and significantly narrowed the Cork Committee's recommendations on wrongful trading.[21]

1.33 However, the report reaffirmed the OFT's view that voluntary action on a sector-by-sector basis was the way forward.[22] The OFT also called for statutory powers to impose suitable compulsory arrangements, in the event that industry was not prepared to take the first step. It suggested that protection of consumer prepayments could also form part of a statutory duty on company directors to act fairly.[23]

2006: OFT Report in response to Farepak

1.34 Between the 1980s and 2006, several OFT reports drew attention to problems in protecting consumer prepayments, including a report on furniture and carpets in 1990.[24] In 2006, following the collapse of Farepak, the OFT once again published an extensive report on the topic.[25] It examined the regulatory framework surrounding consumer prepayments in general, and the Christmas hamper market in particular.

What happened in Farepak?

1.35 Farepak was a Christmas savings club. Consumers chose gift vouchers and other products such as hampers from a catalogue in January and paid for them weekly or monthly until October – normally by cash or cheque. The gift vouchers and goods would then be delivered in November in time for Christmas. Payments were not collected by Farepak directly, but by agents who were usually friends or relatives of the customer. Farepak was not regulated like other savings products because consumers were, in fact, purchasing gift vouchers and other goods (albeit with payment in advance).

1.36 In October 2006, Farepak went into administration and was unable to deliver the gift vouchers and products for which 114,000 consumers had prepaid during the year. At the time of its collapse, it held upwards of £38 million in consumer prepayments. Consumers had saved an average of £400 each, but some had saved close to £2,000.[26] An aggravating factor in the Farepak case was that the savers were financially vulnerable and could ill afford such losses. While they seemed to be aware of other ways of saving, they liked the fact that their money was "locked away" until Christmas and placed great trust in the community-based agent model which Farepak operated.

[21] Above, paras 4.9 to 4.15.

[22] Above, section 7. We discuss sector-specific protection in Chapter 6.

[23] Above, para 4.25.

[24] Office of Fair Trading, *Furniture and carpets: A report by the Director General of Fair Trading* (February 1990).

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

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

1.37 The failure of Farepak caused widespread concern. Immediately following its collapse, the then Department of Trade and Industry set up the Farepak Response Fund. It received donations of more than £7 million and was able to provide some relief to consumers before Christmas. A number of inquiries and investigations were conducted to determine what had happened. Action against the former directors of Farepak was eventually abandoned in June 2012. We return to this in Chapter 4.

1.38 As unsecured creditors in Farepak's insolvency, consumers stood to receive less than 15% of their money back. However, taking payment from the Farepak Response Fund and an additional voluntary payment of £8 million from the company's bank to affected consumers,[27] the final outcome for the consumers was approximately 50 pence for every pound saved. However, some of this payment took several years to be distributed.

The OFT's recommendations

1.39 The OFT's preferred approach was to give consumer creditors preferential status, as they were less able to assess insolvency risk than trade creditors or institutional lenders. The OFT did not reach a full decision on whether "all consumers should be moved up the list of creditors or only those who have made prepayments". It suggested that "prepayments are certain in value and easier to process" but thought that there were also arguments for improving the position of consumers generally. The OFT said that this would need detailed consideration.[28]

1.40 The OFT also suggested placing enhanced duties on directors, rendering them personally liable if they used consumers' money for purposes unrelated to those for which it was originally paid.[29]

1.41 In contrast, the OFT did not believe that there was a case for the regulation of all prepayments. It noted that many businesses depended on prepayments to provide working capital. Regulation would impose compliance costs which would probably be passed to consumers – and there would also be costs relating to enforcement.[30]

1.42 However, the OFT wished to encourage voluntary protections through codes of practice. It reaffirmed that prepayment protection should remain a core criterion of its Consumer Codes Approval Scheme, even though this was a particularly difficult criterion to meet.[31]

[27] We discuss the circumstances in which this voluntary payment came about in Chapter 4.

[28] Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006) para 42.

[29] Above, para 46.

[30] Above, paras 53 to 55.

[31] Above, paras 82 and 83. We discuss the Consumer Codes Approval Scheme, now administered by the Chartered Trading Standards Institute, from para 6.8.

2009: Consumer Focus Report

1.43 In 2009, Consumer Focus, the then statutory body (whose functions are now discharged by Citizens Advice), examined the issues surrounding consumer prepayments once again. Following consumer research, it calculated that in the preceding two years, consumers in the United Kingdom had lost £133.3 million in prepayments, though not all these losses were caused by retailer insolvency.

1.44 The report found that the current consumer protection mechanisms are "confusing, inconsistent and have failed to keep pace with the changing economy".[32] It recommended a combination of measures to protect prepayments.

1.45 Some of these measures related to insolvency law. The report argued that consumers should have preferential status on insolvency because they were less able than most other categories of creditor to assess the risk of a business failing. It was also said to be needed to protect financially vulnerable consumers, who were disproportionally affected by insolvency.[33] Further, the report said that the wrongful trading provisions in the Insolvency Act 1986 should be reformed, to make them easier for consumers to use and to prevent directors from using consumer deposits for purposes unrelated to those for which the payments were originally made.[34]

1.46 Other recommendations related to sector-specific protection, particularly in the furniture, electrical goods and travel sectors. Consumer Focus recommended enacting a reserve power. This would allow the Secretary of State to require businesses carrying on specified activities to establish means to protect prepayments if the need arose. Finally, Consumer Focus recommended that debit card payments should be protected in the same way as credit card payments.

1.47 In July 2009, the Consumer White Paper said that the Government would reassess the regulatory framework for prepayments in general, taking account of advice from the OFT, the Financial Services Authority (now the Financial Conduct Authority) and the Consumer Focus Report.[35] However, no formal consultation on the issue was carried out.

THEMES FROM PREVIOUS REPORTS

1.48 Loss of consumer prepayments on retailer insolvency is not a problem which consumers face every day. However, when it does happen, the loss for consumers – and both secured and unsecured creditors in general – can be significant. Lost prepayments may also damage consumer confidence in the retail sector generally.

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

[33] For example, Consumer Focus' evidence suggested that companies which market their products and services to low income consumers are more likely to fail. Consumer Focus also noted that the prepayment protection which credit cards provide may not be desirable for – or even available to – these consumers. S Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009) p 36.

[34] Above, p 4.

1.49 Over the last five decades, the issue has repeatedly come to the fore. Reports have discussed three possible solutions:

(1) a change to insolvency law;

(2) voluntary sector-specific protections, possibly backed by regulation; and

(3) imposing liability on those who issue credit and debit cards.

A change to insolvency law?

1.50 Views have been split on whether consumers should be treated more generously than other creditors. Typically, when a retailer becomes insolvent, many other creditors will be owed money, including suppliers, contractors, landlords and utility companies. The Cork Committee believed that all these people should be treated equally. It argued that consumers should be given no special status, as when they do lose money they generally lose affordable sums - unlike some small businesses, for whom the retailer's insolvency may spell disaster.

1.51 On the other hand, the OFT and Consumer Focus pointed out that consumers, unlike many other creditors, do not understand the risk they are taking: money taken from unsuspecting consumers should not be used to pay a company's other debts. However, both acknowledged that more data was needed to explore the effects of this change, particularly on the cost of lending.

1.52 The Cork Committee recommended sanctions against directors who took consumer prepayments knowing that their financial difficulties were such that they might not be able to deliver the goods, and without putting the funds in trust. Subsequent reports have pointed to weaknesses in the provisions on wrongful trading liability which were later introduced.

Sector-specific protection

1.53 There have been many calls for trade bodies to encourage their members to protect prepayments through voluntary action. These actions include holding consumer prepayments on trust, or protecting them through insurance or bonding. As the OFT has acknowledged, this is often difficult for businesses: putting money into trust deprives businesses of working capital, while insurance can be difficult to obtain and expensive and a bond may not provide adequate cover. Progress has been slow.

1.54 Some reports have called for such actions to be required through regulation (or at least the threat of regulation). To this end, both the OFT in 1984 and Consumer Focus in 2009 have suggested that Parliament should grant powers to Government departments to regulate if necessary.[36]

[35] HM Government, *A Better Deal for Consumers: Delivering Real Help Now and Change for the Future* (July 2009) p 59.

[36] 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.

Liability on debit and credit card issuers

1.55 As we discuss in more detail in Chapter 5, consumers who pay by credit or debit card for undelivered goods and services may have recourse against their card issuer. These protections are partly statutory (in respect of credit cards only, under section 75 of the Consumer Credit Act 1974) and partly voluntary (where card issuers agree to refund payments to the consumer and then recover the loss under Visa and MasterCard's "chargeback" arrangements).

1.56 These provisions are of major importance to consumers in many situations, particularly following retailer insolvency. The OFT remarked that voluntary chargeback, though useful, could never provide a guarantee that consumers would get their money back.[37] Consumer Focus suggested that the Government should consider introducing statutory protection for consumers who used debit cards.[38]

OUR WORK SO FAR

1.57 In the initial phase of our work, we have tried to understand more about how retailer insolvencies work in practice.

1.58 Previous reports noted that any detailed reconsideration of insolvency priorities would require more information about how money was actually distributed following retailer insolvency. We therefore identified a sample of 20 large high street retailer insolvencies from 2008 to 2014, gathering the data available from public sources (mainly directors' statements of affairs and administrators' progress reports). We also talked to administrators who gave us a more qualitative and nuanced understanding of how and why decisions are reached. The Institute of Chartered Accountants of England and Wales kindly provided us with a sample of eleven smaller insolvencies which affected consumers, so we could see how far the outcomes of insolvencies of larger businesses also applied to smaller ones.

1.59 We are much indebted to Citizens Advice for providing us with consumers' perspective on these issues. Citizens Advice staff identified 810 cases involving consumer prepayments from bureau evidence forms and from calls to their Consumer Service and its predecessor, Consumer Direct.[39] They sent us an anonymised analysis of these cases which identified key themes, illustrated with case histories. We draw on these case studies throughout this report.

[37] Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006) para 36.

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

[39] The Citizens Advice Consumer Service provides confidential and impartial advice on consumer issues.

1.60 The Chartered Trading Standards Institute (CTSI) has now taken over the role of the OFT in approving trade bodies' consumer codes.[40] It shared its experiences with us. We talked to the UK Gift Cards and Vouchers Association and the Furniture Ombudsman about the difficulties of introducing voluntary protection in these sectors.[41] It was also interesting to hear from the Association of British Travel Agents (ABTA) how the travel sector has overcome many (if not all) of these challenges.

1.61 Finally, we were keen to understand more about the "card cycle" through which payments by credit and debit card are made and the ways in which these transactions could be reversed. We are grateful to both Visa and MasterCard for holding telephone conferences with us, and to the card issuer and the merchant acquirer who spoke to us in depth.[42]

1.62 A list of the organisations we have talked to is given in Appendix A. We would like to thank the many people who have helped us and who have spoken to us so candidly.

THE STRUCTURE OF THIS CONSULTATION PAPER

1.63 This paper is divided into 13 further chapters.

1.64 The next two chapters explain the current position of consumers when a retailer becomes insolvent. Chapter 2 summarises the legal rules: we describe how administration works, and set out how a company's assets are distributed on liquidation. Chapter 3 then illustrates how those rules apply in practice, using a sample of insolvencies relating to 20 major high street retailers and 11 smaller businesses.

1.65 The following four chapters look in more detail at specific issues:

(1) Chapter 4 considers how far directors are held to account when they take prepayments from consumers knowing that there is a risk that the contracts might not be fulfilled. The law provides some mechanisms for this: directors may be held liable for wrongful trading or disqualified from acting as directors of other companies. However, the mechanisms are relatively weak when it comes to accepting consumer prepayments. In particular, directors are not liable for wrongful trading if there was a reasonable prospect of avoiding insolvency.

(2) Chapter 5 looks at the protections available when consumers pay by credit or debit card. These are partly statutory (under section 75 of the Consumer Credit Act 1974) and partly voluntary (under card scheme "chargeback" arrangements). In practice, chargeback is of major importance to consumers.

[40] These terms, and the cycle of payments by credit or debit card, are explained in Chapter 5.

[41] We would also like to thank the individual businesses who spoke to us about the difficulties of trust arrangements and the insurance brokers who shared their experiences of insurance arrangements.

[42] We explain the functions of the card issuer and merchant acquirer in Chapter 5.

(3) Chapter 6 describes the various sector-specific schemes set up to protect consumer prepayments. We start by looking at voluntary schemes, such as those set up under CTSI's Consumer Codes Approval Scheme. We then look at schemes with statutory backing.

(4) Chapter 7 considers specific issues raised by gift cards and vouchers.

1.66 This is followed by a short assessment of the current situation in Chapter 8.

1.67 Chapters 9 to 13 set out our proposals and questions:

(1) Chapter 9 looks at ways in which chargeback arrangements can be made more open and accessible.

(2) Chapter 10 examines the mechanisms open to retailers and traders to protect consumer prepayments.

(3) Chapter 11 considers whether protection can be achieved on a voluntary basis or whether there is a need for regulation.

(4) Chapter 12 proposes that some limited consumer claims should be given preferential status, ranking behind employees but in front of floating charge holders. This would apply where the consumer provided a significant sum of new money to the business in the run up to the insolvency, using a payment method which did not offer a chargeback remedy.

(5) Chapter 13 looks at when consumers acquire ownership of the goods they have ordered. We propose to introduce new, simpler rules setting out when ownership in goods passes to consumers.

1.68 Finally, Chapter 14 lists our proposals and questions.

NEXT STEPS

1.69 We seek responses to our proposals and questions by 17 September 2015. Information about how to respond is included at the beginning of this document. Our aim is to provide a final report to the Department of Business, Innovation and Skills by summer 2016.

CHAPTER 2
THE CURRENT POSITION OF CONSUMERS ON RETAILER INSOLVENCY

2.1 This chapter looks at how the law governing insolvent companies affects consumers. When a retailer becomes insolvent, the consumer no longer has a right against the company to use gift vouchers, receive goods for which they have paid a deposit, or get their money back. Instead, a consumer becomes one of very many creditors, all seeking a share of the company's remaining assets.

2.2 Our analysis of high street insolvencies, discussed in Chapter 3, shows that consumers are not entirely unprotected. They may receive some value for their prepayments in one (or more) of the following ways:

(1) The administrator may decide to honour the prepayment (in full or in part) while the company is in administration.

(2) A subsequent purchaser of the business may choose to honour the prepayment (again, in full or in part).

(3) The company may have ring-fenced consumer prepayments by segregating them from its own funds and holding them on trust.

(4) A consumer may assert ownership of the goods which have been paid for.

(5) Consumers who have paid by credit or debit card may get a refund from the bank which issued the card.

(6) On liquidation, consumers may receive a dividend for their unsecured claim, though this will usually be negligible.

2.3 It is reasonably common for either administrators or the subsequent purchaser of the brand to honour gift vouchers or attempt to fulfil orders, but this is by no means universal. There is no obligation on either administrators or purchasers to do so. Indeed, any action taken by the administrator which indirectly favours consumers (such as allowing gift vouchers to be redeemed during a period of trading in administration) must be for the benefit of the creditors as a whole.

2.4 In a few of the cases we look at in Chapter 3, trusts were established in favour of consumers when the retailer's financial problems became acute. Where consumers enjoyed the benefit of a trust, their claims were usually paid in full. The analysis also highlights the importance of "chargeback" claims against banks that issue credit and debit cards.

2.5 However, if these forms of protection are unavailable, it is very likely that consumers will receive no more than a negligible payment as a dividend on liquidation. Consumers rank as unsecured creditors near the bottom of a "statutory hierarchy" of creditors. Dividends to unsecured creditors following a retailer's insolvency are typically less than one penny in the pound.[1]

2.6 In this chapter we outline the law which underpins these various forms of protection. We start by explaining the nature of administration, looking in particular at administrators' powers to honour consumer prepayments and to sell the business. We then set out the statutory hierarchy of creditors. Clearly, providing more protection for consumers would mean less protection for other creditors, and we need to understand the winners and losers in the current system.

2.7 We then consider how trusts can be used to protect consumer prepayments, and when ownership of goods passes to consumers. Finally, we look briefly at when consumers who have paid by credit or debit card have recourse against their issuing bank: we return to this in Chapter 5.

2.8 In Chapter 4, we consider whether consumers can claim against the directors of a company who took prepayments for goods or services which they knew were unlikely to be supplied. As we will see, although directors may be liable in some circumstances, such actions are difficult to bring and even more difficult to win.

INSOLVENCY

2.9 A company is insolvent 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").[2] In these circumstances, the directors lose control of the company. An insolvency practitioner (usually an accountant) will step in to take control, acting in accordance with statutory rules.

2.10 There are two main forms of insolvency proceedings – liquidation and administration:

(1) In liquidation, the company's assets will be sold and the proceeds distributed to the various creditors in accordance with the hierarchy set out in legislation. A business may go straight into liquidation.

(2) However, some companies enter a period of administration before this happens. The insolvency practitioner (or "administrator") may choose to continue trading while working out the best way of dealing with the business, if possible saving it or selling it as a going concern to a third party.

[1] See from para 3.31.

[2] Insolvency Act 1986, ss 123(1)(e) and 123(2) respectively; see also *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL PLC* [2013] UKSC 28, especially at [1].

2.11 While the company is in administration a moratorium is imposed, which means that creditors are barred from bringing legal action against the company.[3]

Administration

2.12 Administration is intended to be a short-term measure, focusing on a particular objective.[4] The Insolvency Act 1986 sets out the following three objectives, in descending order of priority:

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

(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.[5]

2.13 The Insolvency Act 1986 gives administrators considerable discretion about how the objective is achieved. For example, administrators have a general power to do anything "necessary or expedient for the management of the affairs, business and property of the company".[6] Similarly, administrators may make payments if they think it "likely to assist achievement of the purpose of administration".[7] 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 over others.

2.14 The first statutory objective is achieved only rarely. A 2006 study found that less than 10% of administrations rescued the company as a going concern.[9]

2.15 Instead, most administrators aim to secure a better result for the creditors by selling the business. In most retailer insolvencies, the business – or parts of it, such as intellectual property rights – will be sold and the purchasers will set up a new company to house it (sometimes called a "Newco"). The proceeds of this sale will then be distributed to creditors, who generally receive only a proportion (often a very small proportion) of their original claims. A new purchaser may be seen to be "cherry-picking" bits of the business, discarding its liabilities to creditors, as these remain with the original company.

2.16 Although the business may well continue, the company itself does not. Even where the purchaser retains the brand name, and the public sees no difference, the original company will usually be liquidated and its creditors will suffer a loss.

[3] Insolvency Act 1986, para 42 of sch B1.

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

[5] Insolvency Act 1986, para 3 of sch B1.

[6] Insolvency Act 1986, para 59(1) of sch B1.

[7] Insolvency Act 1986, para 66 of sch B1. Such payments, however, do not extend to the satisfaction of creditors' claims.

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

[9] A Katz and M Mumford for the Insolvency Service, *Study of Administration Cases: Report to the Insolvency Service* (October 2006) p 34.

2.17 As soon as administrators are appointed, they will normally start soliciting offers from prospective purchasers. However, in the case of a pre-packaged administration or "pre-pack", a sale will have already been agreed before the company enters administration.[10] "Pre-pack" administrations are often criticised because the company's financial difficulties are not widely known in advance of the announcement of the sale, so consumers (and other creditors) are taken by surprise. As we discuss in Chapter 3, in some cases (such as in the case of Dreams) the terms of the pre-pack deal will be favourable to consumers; although in other cases (such as in the case of JJB Sports) they are not. We have no evidence to suggest that pre-packs cause more detriment to consumers than other insolvencies. However, where they do cause detriment, consumers may be particularly shocked and incredulous.

Honouring prepayments during the administration

2.18 Administrators may decide to continue trading in administration.[11] Continued trading might enable surplus stock to be sold to consumers at a higher price than it would be in liquidation (especially if it were sold in bulk at a discount), and a business which is still trading will be more attractive for a potential purchaser.

2.19 This opens up the possibility that administrators may honour gift vouchers or deliver prepaid goods during a period of trading in administration. Administrators have the power to do this, but only if it would help meet one of the statutory objectives. Effectively, this means that administrators may only honour commitments to consumers if they reach the commercial decision that this would "achieve a better result for the company's creditors as a whole".[12] In other words, administrators are not obliged to accept gift vouchers or fulfil consumer orders; nor are they permitted to do so if this would damage the interests of other creditors.

2.20 Both the decision to continue trading and, if so, the decision as to whether consumer prepayments should be honoured, are based on the commercial reality of the business. We have talked to administrators about how these decisions are made, and discuss this issue in Chapter 3.

[10] For a recent report into the pre-pack administration procedure, see the *Graham Review into Pre-pack Administration* (June 2014), https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration.

[11] 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". No court approval is necessary for particular commercial decisions the administrator adopts: *MTI Trading Systems v Winter* (1998) BCC 591. See also the discussion in Chapter 3 on periods of trading in administration from para 3.47 onwards.

[12] Insolvency Act 1986, para 3 of sch B1.

Subsequent purchaser choosing to honour consumer prepayments

2.21 An administrator's main aim will be to seek a purchaser for the business as a going concern. The administrator will normally discuss the issue of consumer prepayments with potential purchasers and the purchaser may decide to honour them, despite there being no legal obligation to do so.[13] This can ensure continuing consumer goodwill in the business and bring people into stores.

2.22 In Chapter 3, we discuss how often this occurs. An example of purchasers honouring consumer prepayments is Game, where the purchaser decided "post-sale" to honour gift vouchers. However, when Sports Direct purchased Republic, it did not honour gift cards purchased prior to the administration on the basis that it was not legally required to do so.

Dividends to consumers as unsecured creditors

2.23 If administrators or new purchasers fail to honour the outstanding obligations to consumers, consumers (alongside others such as trade creditors and landlords) will be unsecured creditors. As discussed below, unsecured creditors take a share of any assets remaining after secured and preferential creditors have been paid.

2.24 It will often take some time for any payment to be made. Although administrators have a power to make distributions to unsecured creditors during the administration, they have to seek the court's permission to do so.[14] Furthermore any distribution would be to *all* unsecured creditors. In retail insolvencies, administrators will rarely invoke this power given the complexity and number of claims.

2.25 Normally, any distribution to unsecured creditors will occur after administration, once the company proceeds to liquidation (whether the brand is sold or not). If there are remaining funds for unsecured creditors, administrators will move the company into liquidation; if not, administrators will seek dissolution of the company.

2.26 On liquidation, any payment to unsecured creditors is likely to be negligible. Consumers rank as unsecured creditors at the bottom of the statutory hierarchy, which we explain in detail below. After payments have been made for expenses of the administration, to fixed charge holders, to preferential creditors and to floating charge holders, very little will be left over for unsecured creditors.

THE STATUTORY HIERARCHY OF CREDITORS

2.27 On liquidation, a company's assets must be distributed to creditors according to the following hierarchy:

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

[13] Although the purchaser may be trading under the same brand, the consumer will now be dealing with a separate legal entity which is not responsible for debts owed by the company in administration. See also paras 2.15 to 2.17.

[14] Insolvency Act 1986, para 65 of sch B1.

(2) Expenses of the administration or liquidation;

(3) Preferential creditors;

(4) Floating charge holders (less the prescribed part);[15]

(5) Unsecured creditors; and

(6) Shareholders and members.

2.28 We explain each rung of this hierarchy in more detail below.

2.29 Apart from fixed charge holders, whose dividend is limited by the value realised from their security, each category of creditor must be paid in full before any distribution to the next category is considered. 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.[16]

2.30 Insolvency practitioners are required to ensure that known creditors are aware that the company is in liquidation or administration, and therefore have a chance to lodge claims.[17]

Fixed charge holders

2.31 Holders of a fixed charge are "secured creditors". They have secured their loan to the company through a charge, registered at Companies House, over a specific asset or assets. Examples include fixed charges over real property, fixtures and fittings, intellectual property, computer equipment or plant and machinery. Secured creditors are usually banks, financial institutions or investment and finance companies.

2.32 After deducting the costs of realisation, the insolvency practitioner must use the proceeds of sale of each asset to satisfy the fixed charge holder's claim. These proceeds of sale are not available to other creditors unless the fixed charge holder has been paid in full; the fixed charge ring-fences the asset from the general body of creditors.

2.33 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. In some cases, an asset will have more than one fixed charge over it, which may result in satisfaction of the first charge holder's claim, but not that of a second charge holder whose priority is lower.

[15] The prescribed part is explained from para 2.51.

[16] To illustrate this, we discuss the outcomes in a number of recent insolvencies in Chapter 3.

[17] See, for example, Insolvency Act 1986, para 46(3)(b) of sch B1.

Expenses of the administration or liquidation

2.34 The expenses of the administration or liquidation cannot be discharged from assets subject to a fixed charge,[18] but they are paid in priority to other claims.[19]

2.35 Administrators' or liquidators' professional fees are an expense of the administration and fixed by the creditors' committee.[20] They may be challenged by creditors, though if a group of unsecured creditors wishes to do so, that group must represent at least 10% in value of the unsecured claims.[21] In the context of consumers and retailer insolvency, this is unlikely to happen given the low value of individual claims and the resulting need to marshal an extremely large number of creditors.

2.36 However, expenses of the administration include much more than just professional fees. They include any "expenses properly incurred by the administrator in performing his functions in the administration of the company".[22] Further, any sum payable in respect of a debt or liability arising out of a contract entered into by the administrator has "super-priority" over other expenses.[23]

2.37 The important distinction here is between liabilities entered into by the administrator (which are paid as an expense of the administration) and those which arose before the administration (which generally rank as unsecured debts). However, this area of law is far from straightforward. As far as they can, creditors will try to argue that any liability relates to the post-administration period, and therefore they should be paid for the service they have provided. The issue has resulted in much recent litigation, leading Mr Justice Briggs to describe the situation in one particular context as "a legislative mess".[24]

[18] Lightman and Moss, *The Law of Administrators and Receivers of Companies* (5th ed; 2011) at para 4-010: "Assets subject to a fixed or specific charge are treated as belonging in equity to the charge-holder and from the outset… Assets subject to fixed security have never been thought to be available for discharging the expenses of a liquidation which is conducted for the benefit of unsecured creditors of the company."

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

[20] Insolvency Rules 1986, rule 2.106.

[21] Insolvency Rules 1986, rule 2.109.

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

[23] See, for example, *Bloom and others v Pensions Regulator (Nortel, Re)* [2010] EWHC 3010 (Ch).

[24] *Bloom and others v Pensions Regulator (Nortel, Re)* [2010] EWHC 3010 (Ch) at [199]. This case concerned certain additional payments to an occupational pension scheme to be made pursuant to a Financial Support Direction under the Pensions Act 2004. For further discussion of expenses of the administration see Stephen Davies QC, Guildhall Chambers, "Administration Expenses" (January 2010).

2.38 The practical effect appears to be as follows:

(1) Rent, usually paid quarterly, is payable as an expense of the administration on a "pay-as-you-go" basis. This was recently confirmed by the Court of Appeal in a case involving the administration of the retailer Game.[25] Administrators must pay for the period they remain in occupation for the purpose of the administration, irrespective of whether rent falls due before or after the company enters administration.

(2) Business rates are payable as an expense of the administration,[26] unless the premises are empty.[27]

(3) Although the Court of Appeal had decided that pension liabilities such as a Financial Support Direction would be an expense of the administration, this decision was later reversed by the Supreme Court.[28]

(4) VAT and PAYE accrued during a period of trading in administration are each payable as an expense of the administration; sums accrued prior to the appointment of administrators remain unsecured claims.[29]

(5) For utility contracts, only what is actually used for the purposes of the administration will rank as an expense of the administration. From the time an administrator ceases to occupy the premises, the utility provider will have an unsecured claim.[30]

(6) Where employees work during a period of administration, they will be paid for this as an expense of the administration.

Preferential creditors

2.39 After deduction of the expenses of the administration or liquidation, the claims of preferential creditors are paid in priority to all other debts.[31]

[25] See *Jervis v Pillar Denton; re Game Station* [2014] EWCA Civ 180. Permission to appeal was denied by the Supreme Court on 31 October 2014.

[26] *Exeter City Council v Trident Fashions* [2007] EWHC 400 (Ch), [2007] Bus LR 813.

[27] Non-Domestic Rating (Unoccupied Property) (England) Regulations 2008, reg 4(l).

[28] *Bloom and others v Pensions Regulator and others* [2013] UKSC 52 (reversing [2010] EWHC 3010 (Ch)). See also http://www.thepensionsregulator.gov.uk/press/pn13-27.

[29] See para 5.5 of http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ShowContent&propertyType=document&id=HMCE_CL_000122. See also para 2.40 and accompanying footnote.

[30] *Christine Mary Laverty and others as Joint Liquidators of PGL Realisations PLC and others v British Gas Trading Limited* [2014] EWHC 2721.

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

2.40 The list of preferential creditors was reduced in 2003, when the Crown gave up its preferential status for VAT and PAYE claims accrued prior to the administration or liquidation.[32] For practical purposes, the only debts now given preferential status are owed to employees.[33] The list is set out in schedule 6 to the Insolvency Act 1986 and includes:

(1) Contributions to occupational pension schemes;

(2) Arrears of wages owed to employees for the four month period prior to the administration or liquidation, subject to a cap (currently £800)[34];

(3) Holiday pay owed to employees.

The treatment of employees

2.41 Although employees are said to have preferential status, their treatment on insolvency is rather complicated. If they continue to work during the administration, they are paid for this as an expense of the administration.

2.42 For other claims, the Government guarantees a basic minimum of payments. The money comes from the National Insurance Fund and is administered by the Redundancy Payments Service (RPS), part of the Insolvency Service. These arrangements cover statutory redundancy and other contractual payments including: [35]

(1) up to eight weeks' arrears of pay, including a payment for a protective award for failing to consult collectively;

(2) up to six weeks' of accrued holiday pay;

(3) pay in lieu of notice; and

(4) unpaid pension contributions.

2.43 All payments are subject to a cap - currently £475 per week.[36] It is for the Secretary of State to determine how much each employee is entitled to.[37]

[32] See Department for Trade and Industry (July 2001), *Productivity and Enterprise: Insolvency – A Second Chance* at para 2.19, which noted a trend in other countries, such as Germany and Australia, of abandoning any preference for debts owed to the state. This was implemented by the Enterprise Act 2002. VAT and PAYE now rank as unsecured claims.

[33] 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.

[34] Insolvency Proceedings (Monetary Limits) Order 1986, SI 1986/1996, art 4.

[35] Employment Rights Act 1996, Part XII.

[36] 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.

[37] Employment Rights Act 1996, s 182.

2.44 Although there is some overlap between an employee's preferential claim against the insolvent estate and their claims against the RPS, the liabilities of the estate and the RPS to the employee are not identical. While the preferential claim covers arrears of salary for up to four months, capped at £800, the RPS covers only eight weeks. On the other hand, payment from the RPS is not capped at £800 and also covers redundancy payments. This means that the Government is able to recoup some, but not all, of its payments against the company as a preferential claim.[38] The balance is reclaimable only as an unsecured debt.

2.45 Employees may sometimes be owed money in addition to these categories. They may, for example, be owed contractual redundancy pay for a greater amount than the statutory minimum. These debts will be unsecured, and employees are likely to receive only a minimal amount.

2.46 In all the high street insolvencies we looked at, preferential claims were paid in full and some money was left over for floating charge holders.

Floating charge holders (less the prescribed part)

2.47 Most finance providers (such as banks or investment funds) will secure their loan to the company through a combination of fixed and floating charges.

2.48 Like fixed charges, floating charges must be registered at Companies House. While a fixed charge operates over a specific asset, a floating charge applies to a class of the company's assets or, more usually, to all of the company's assets, both present and future.[39] This includes, for example, stock and money in bank accounts. A floating charge allows businesses to offer security to creditors even where there are no specific assets over which a fixed charge could be created. On insolvency, the floating charge "crystallises" over the assets the company owns at that moment.

2.49 In some cases there may be successive floating charges with different priorities, resulting in a ranking of floating charge holders similar to that of fixed charge holders, discussed above.[40]

2.50 In the high street insolvencies we looked at, the floating charge holders usually received a substantial payment, but less than their full entitlement.

[38] 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.

[39] See Romer LJ in *Re Yorkshire Woolcombers Association Limited* [1903] 2 Ch 284, 294 to 295.

[40] The ranking of such charges may be determined by the time at which each charged is registered, or by the terms of the charges themselves.

The prescribed part

2.51 Up until 2003, it was common for floating charge holders to take all a company's remaining assets, providing nothing for unsecured creditors. However, following the Enterprise Act 2002, some money must be set aside for unsecured claims before the floating charge holder may be paid.[41] This is referred to as "the prescribed part".

2.52 The amount which is to be prescribed is determined by order of the Secretary of State.[42] It is currently calculated as follows:[43]

(1) 50% of the company's net property[44] up to £10,000; and

(2) 20% of the company's net property in excess of £10,000.

This is subject to a statutory maximum of £600,000.

2.53 In most of the large high street insolvencies we looked at, the prescribed part was the statutory maximum of £600,000. However, this was usually extremely low in comparison to the volume of unsecured claims.

2.54 As we explore in Chapter 3, the costs of distributing the prescribed part tend to be high (£150,000 or more) and the yields to creditors tend to be low (less than one penny in the pound), The insolvency practitioner may apply to the court for an order to disapply the prescribed part if the cost of distributing it to unsecured creditors would be disproportionate to the benefits.[45]

Unsecured creditors

2.55 After the floating charge holders have been paid, any remaining assets are divided among the remaining unsecured creditors. Each receives the same proportion of their debt. Unsecured creditors are often numerous and include:

(1) Trade creditors (such as suppliers), utility companies, local authorities for business rates, and landlords;

(2) HMRC, for tax incurred before the administration; and

(3) Consumers, including prepaying consumers.

[41] Insolvency Act 1986, s 176A. The aim of the prescribed part is to ensure that the abolition of the Crown's preference for VAT and PAYE also benefits unsecured creditors in cases where there are also floating charge holders.

[42] Insolvency Act 1986, s 176A(8)(b).

[43] Insolvency Act 1986 (Prescribed Part) Order 2003, s 3.

[44] The "net property" in this context is the property available to floating charge holders.

[45] Insolvency Act 1986, s 176A(5). See, for example, *Re Hydroserve Ltd* (2008) BCC 175 at [3] to [4].

2.56 Out of the 20 high street administrations we have looked at, three had no floating charge holders and in one assets remained after the floating charge holders had been paid.[46] In all other cases, the only assets available for distribution to unsecured creditors were the prescribed part, meaning that the amount available to be divided among unsecured creditors was limited to £600,000.

Shareholders and members

2.57 Any surplus – of which there is generally none in an insolvency situation - will be distributed to shareholders and members of the company.

TRUSTS

2.58 It is possible for retailers to ring-fence consumer prepayments in a trust. Where a trust is established, consumers are said to have a "beneficial interest" in the money. This means that, on insolvency, the money still belongs to the prepaying consumers rather than the company. It 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.

2.59 Companies can set up trusts on a voluntary basis but they are under no general obligation to do so. In *Twinsectra*, Lord Millett reiterated this point:[47]

> Payments in advance for goods or services are paid for a particular purpose, but such payments do not ordinarily create a trust. The money is intended to be at the free disposal of the supplier and may be used as part of his cashflow.

The *Kayford* case

2.60 A 1975 case endorsed the use of trusts to protect consumer prepayments.[48] Shortly before the mail-order company Kayford entered administration, it sought to establish a trust to ring-fence customer payments by opening a separate "Customers' Trust Deposit Account". The company initially paid the consumer funds into a dormant deposit account in the company's name and did not change the name of the account until later. However, the court found that discussions between the firm's directors, accounts and bank manager evidenced a sufficient intention to create a trust.

2.61 Mr Justice Megarry commented that, where the public had paid money in advance in return for the future supply of goods and services, setting up a trust was "an entirely proper and honourable thing". He said:[49]

> No doubt the general rule is that if you send money to a company for goods which are not delivered, you are merely a creditor of the company unless a trust has been created.

[46] Land of Leather, Zavvi and Blockbuster had no floating charge holders. There were sufficient assets in La Senza to permit a distribution to unsecured creditors beyond the prescribed part. See paras 3.21 and 3.31 to 3.33.

[47] *Twinsectra Ltd v Yardley* [2002] 2 AC 164 at [73].

[48] *Re Kayford Ltd* [1975] 1 WLR 279.

[49] Above, at 282.

2.62 However, he went on to say that if the company took suitable steps to set up a trust on or before receiving the money, then the money in trust could be repaid to the consumers:[50]

> The obligations in respect of the money are transformed from contract to property, from debt to trust.

The requirements for a trust

2.63 It is common to describe trusts set up to protect consumer prepayments as "Kayford trusts". However, the case did not establish any special rules about these trusts. Instead, the general law of trusts applies. To create a trust there must be certainty of intention, subject matter and object.[51] In practice, this means that it is not enough simply to pay the money into a separate bank account as the company will still own the money absolutely. The company needs to show a clear intention to establish a trust, preferably (but not necessarily) through a trust deed drawn up by a lawyer.

2.64 To set up a trust, money should be set aside and not used for other purposes. The company cannot use the money as working capital, for example to pay suppliers.

2.65 Furthermore, many retailers are unable to put money aside in this way: furniture retailers, for example, depend on consumer prepayments to fund orders from suppliers. The Cork Committee welcomed the case of *Re Kayford* but it rejected the idea that companies should be under a statutory obligation to create trusts for consumers, mainly due to concerns about restriction of working capital.[52]

Problems in establishing trusts

2.66 Even if directors wish to establish a trust for the benefit of consumers, they may face difficulties in doing so. We examine some of these difficulties below.

No preference to existing creditors

2.67 Trusts cannot be used to give a preference to one set of existing creditors over another.[53] This means that directors cannot declare a trust over money they have already received, as the consumers will already be creditors of the company at this stage. However, there is no issue with holding new money they receive subsequent to the establishment of the trust. Consumers who make payments after the trust is set up will be beneficiaries under the trust rather than creditors of the company. As Mr Justice Megarry said:[54]

[50] Above, at 282.

[51] These "three certainties" were first set out in *Knight v Knight* (1840) 49 ER 58.

[52] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558, paras 1050 to 1055.

[53] Insolvency Act 1986, s 239.

[54] *Re Kayford Ltd* [1975] 1 WLR 279 at 281.

> If one leaves on one side any case in which an insolvent company seeks to declare a trust in favour of creditors, one is concerned here with the question not of preferring creditors but of preventing those who pay money from becoming creditors, by making them beneficiaries under a trust.

2.68 The requirement that trusts cannot be used to grant a preference to one set of creditors may cause problems in practice. Shortly before Farepak entered administration, directors attempted to establish a trust for consumer prepayments. However, the court held that the trust was invalid as it constituted a preference.[55] Consumers had given their money to agents (who then forwarded it to Farepak), but the money was deemed to belong to Farepak as soon as the agents received it. The consumers therefore became creditors of the company at this point. A subsequent declaration of the trust at the point the company received the money from the agents was too late.

Administrators' duties

2.69 There is a risk that if the trust lacks the correct legal formalities, administrators may seek to defeat it.

2.70 Administrators are required to act in the interests of the creditors as a whole. This means that they may be required to recoup money held in an improperly-constituted trust for the benefit of all the creditors. In practice, we were told that on appointment administrators will seek legal advice about whether a trust is valid in law. If it is vulnerable to challenge and the administrators consider that the funds might belong to the company, they are obliged to challenge the trust to maximise return to the general body of creditors.

Where no funds are available and mixed funds

2.71 Separating prepayments from other money received by the company can pose practical challenges. The money may be mixed in the till and there is also a danger that payments will not have been placed in the right account. Accounting may also become more difficult.

2.72 If the money which should have been held on trust has in fact been paid to a supplier, landlord or employee, the consumer will merely have a personal claim for breach of trust. Where the monies have been mixed, it may still be possible to trace a particular consumer's payment in a different account, though that is far from straightforward. If it can be traced, that money can be used to repay the relevant consumer.

Trusts in practice

2.73 There are two main situations in which a trust might be created by a retailer:

(1) As a permanent feature of the retailer's business model; or

(2) In the last weeks of trading if there are concerns about insolvency.

[55] *Re Farepak Food and Gifts Limited (in Administration)* [2006] EWHC 3272 (Ch).

Permanent consumer trusts

2.74 In some industries, businesses are required to put client money into a trust account. Examples are estate agents,[56] insurance brokers and investment managers.[57]

2.75 The Estate Agents Act 1979 includes a typical example of a statutory requirement to create a trust. Under section 14, estate agents who receive client money "shall, without delay, pay the money into a client account". To give legal effect to the arrangement, section 13 declares that such client money is:

> held by [the estate agent] on trust for the person who is entitled to call for it to be paid over to him or to be paid on his direction or to have it otherwise credited to him.

2.76 In other cases, businesses establish trusts voluntarily, often as part of a consumer code. For example, members of the Christmas Prepayment Association now hold consumer funds on trust. We discuss these possible means of protection in Chapter 6, and return to them again in Chapter 10.

Trusts in the lead up to insolvency

2.77 Directors of a company facing possible insolvency may also establish a trust for future payments received from consumers, suppliers or employees.[58] This will help to protect the directors from criticism should their efforts to save the company fail, since at least the most recent payments will be protected.

2.78 Our analysis of high street insolvencies revealed two examples of directors creating a trust one month before entering administration.[59] These trusts were successful in repaying consumers who parted with their money shortly before the insolvency and who made a claim on the trust. However, these tended to be set up in the weeks leading up to insolvency, and only prepayments taken after the establishment of the trust were protected.

2.79 One difficulty is that a trust set up rapidly in the face of increasing financial difficulties may be improperly constituted and consequently more vulnerable to challenge by the administrators. This was the case in one of the smaller retailers we analysed.[60]

[56] Estate Agents Act 1979, s 14.

[57] Financial Conduct Authority Rules, Client Asset Rulebook, rule 7.7.

[58] For example, the directors of Game set up a trust for the benefit of employees and HMRC in the final few weeks before administration. See from para 3.42 for examples of trusts set up for the benefit of consumers. See also P Cranston and H Sims, *Twilight Trusts: Protection from those you cannot trust?* (May 2009), http://www.guildhallchambers.co.uk/file s/InsolvSemnotesJune09Twilighttrusts_PeterCranston&HughSims.pdf.

[59] See from para 3.43.

[60] See para 3.46.

Conclusion

2.80 Putting consumer prepayments into trust can be effective where a business does not rely on the prepayments as working capital. However, businesses feel that trusts often involved unnecessary legal and accounting difficulties. Even where trusts are set up, the protection may not be complete.[61] It is also important to note that, where a statutory or regulatory requirement requires a business to hold funds on trust, whether that business has actually or successfully set up a trust will still be a matter of fact. If it has failed to comply with its obligations or if the trust is improperly constituted, the funds will not be protected in the event of insolvency.

2.81 In Chapter 10, we discuss whether trusts can be made easier to establish.

WHO OWNS THE STOCK?

2.82 An important question facing administrators when a retailer becomes insolvent is who owns the stock. If the goods are owned by the retailer, they will be part of the assets available to creditors. However:

(1) The retailer's suppliers may have retained title over some goods, usually because they have not yet been paid.

(2) Ownership of the goods may already have passed to the consumer who has prepaid. If this is the case, the consumer – as the legal owner - will be able to assert a claim over the goods.

2.83 We look at each of these possibilities below.

Retention of title by suppliers

2.84 One way in which suppliers may protect themselves against retailer insolvency is to include "retention of title" clauses in their contracts. Typically, these clauses provide that the retailer does not acquire title to the goods (that is, ownership) until the goods have been paid for. The clauses are often drafted in a way which allows the retailer to sell the goods in the ordinary course of business, but this right terminates on the retailer's insolvency.

2.85 Retention of title clauses prevent the goods from forming part of the retailer's assets on insolvency: rather than having an unsecured claim against the retailer for the value of the goods which have yet to be paid for, suppliers can assert their ownership over the goods and recover them from the administrators.

2.86 Administrators told us that retention of title clauses can cause uncertainty and dispute. The validity of retention of title clauses may be disputed; it may be difficult for the supplier to identify goods subject to such clauses; and suppliers are responsible for collecting the goods themselves. Often, administrators will come to a commercial settlement with the supplier, allowing the administrators to sell individual items of stock on to consumers or in bulk to a purchaser of the brand or other trade customer.

[61] See the discussion in R Hantusch, *Trust claims and client monies: left high and dry or scooping the pool?* (April 2010), http://clients.squareeye.net/uploads/3sb/events/211010_hantusch.pdf.

2.87 As discussed in Chapter 3, the existence of retention of title clauses influences whether a business is able to trade in administration. For example, suppliers to the camera shop Jessops insisted on very strong retention of title clauses (supported by the goods being clearly identifiable through serial numbers) in response to the retailer's previous financial difficulties. As a result, administrators had little "free stock" with which they could continue to trade and no period of trading in administration took place. It was therefore not possible to honour gift vouchers.

Passing of property to consumers

2.88 The next question is whether a consumer who has ordered and paid for the goods can be said to own them. If so, the goods will not form part of the general asset pool: instead they must be made available to the consumer. If not, the administrator can retain the goods and sell them to someone else.

2.89 The case histories provided by Citizens Advice show that this is a live issue. In many cases, consumers thought that goods were ready for collection only to find they were not available when they went to pick them up. This is a typical example:

> 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. Had the staff been misinformed?

2.90 Ownership of property is dealt with in the Sale of Goods Act 1979 (the 1979 Act). Although the Consumer Rights Act 2015 now sets out most of the rules concerning consumer sales,[62] on this issue it refers back to sections 17 and 18 of the 1979 Act.

2.91 Section 17 of the 1979 Act provides a general rule that property is transferred to the buyer when the parties to the contract intend it to be transferred. However, unless a different intention appears, section 18 of the Act sets out rules for ascertaining the intention of the parties. Different rules apply for "specific goods" and "unascertained" goods".

[62] Consumer Rights Act 2015, Part I, especially s 4. It is hoped that this will be brought into force on 1 October 2015.

Specific goods

2.92 "Specific goods" are defined as "goods identified and agreed upon at the time a contract of sale is made".[63] Unless a contrary intention appears, there is a presumption that parties intend property to pass immediately on conclusion of the contract, so long as the contract is unconditional and the goods are in a deliverable state.[64] However, where 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 that thing has been done and the buyer has been notified.[65]

2.93 In the above example, the curtains will be specific goods if they are ready made (for example, in a packet) and available to take away from the shop at the point of purchase. However, there is at least a question about whether the curtains, before the retailer has completed the alterations, are in a "deliverable state". The term is defined in section 61(5) of the Sale of Goods Act 1979:

> 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.

2.94 As the consumer is arguably not obliged to take delivery of the curtains until they have been altered, this would suggest that property has not passed. This could operate harshly against consumers who, in an insolvency situation, would presumably prefer to receive unaltered curtains rather than no curtains at all. In Chapter 13, we make proposals for reform.

Unascertained or future goods

2.95 In many cases the specific items 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 specific item among the many in the warehouse will be used to fulfil the contract, so at the point of order the goods are unascertained. Alternatively, the goods contracted for may not yet be manufactured. These are referred to as "future goods". To use the curtain example, the goods would be unascertained if the consumer ordered curtains based on samples of fabric in a shop, with the consumer's curtains then being made to order.

2.96 For unascertained or future goods, section 18, rule 5 applies, unless a different intention appears. It states that:

> (1) 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 of after the appropriation is made.

[63] Sale of Goods Act 1979, s 61.

[64] Sale of Goods Act 1979, s 18 r 1.

[65] Sale of Goods Act 1979, s 18 r 2.

(2) Where, in pursuance of the contract, the seller delivers the goods to the buyer or to a carrier or other bailee or custodier (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is to be taken to have unconditionally appropriated the goods to the contract.

2.97 The crucial issue here is at what point in time goods are "unconditionally appropriated" to the contract. Rule 5(2) creates a presumption that this happens when the seller delivers the goods to the buyer or to a carrier (such as a parcel company). In this situation, the administrator is unlikely to attempt to recover the goods and the consumer should not lose out.

2.98 Where the goods are in a store or warehouse, the question is more complicated. The meaning of "unconditional appropriation" was considered in *Carlos Federspiel & Co v Charles Twigg & Co.* Mr Justice Pearson noted: [66]

> 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 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.

2.99 In this case, the seller had packaged and labelled goods but had not yet taken them to the ship. Mr Justice Pearson held that the goods had not yet been unconditionally appropriated: they had merely been set aside.[67] However, it is worth noting that the specific nature of the agreement in that case meant that delivery was an integral condition of the contract of sale.

2.100 In a report commissioned for the Department of Business, Innovation and Skills, Professors Howells and Twigg-Flesner comment that:[68]

> 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.

[66] [1957] 1 Lloyd's Rep 240 at 255. See also *Re London Wine Company (Shippers)* [1986] PCC 121 discussed in P Dobson, *Sale of Goods and Consumer Credit* (5th ed 1996) para 3-23.

[67] See Dobson, above, para 3-22.

[68] 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.

2.101 In practice the process of "unconditional appropriation" is not as clear as it should be. It is far from certain, for example, whether the act of altering the curtains outlined above at para 2.88 does or does not show an intention for property to pass. This lack of clear law meant that the administrators we spoke to were not always sure when property passed. Some suggested that property passed when goods were paid for and labelled; others felt more was needed. The lack of clarity on the law means that administrators may err on the side of caution and refuse to release goods which, arguably at least, legally belong to consumers. The issue can cause considerable frustration, especially when consumers see items they have paid for on sale to others. We return to this issue in Chapter 13, where we make proposals for reform.

CREDIT AND DEBIT CARD PAYMENTS

2.102 A consumer who has paid by credit or debit card is able to claim against the bank which issued the card instead of relying on lodging a claim with the administrators of the insolvent company.

2.103 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 the credit card provider for a breach of contract or misrepresentation claim which the consumer could have made against the retailer.

2.104 For other claims – that is for any purchases made by debit card, and for credit card purchases of under £100 – 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 bank will usually refund the amount paid. They will ask the next player in the payment chain, the merchant acquirer,[69] to reimburse them.

2.105 Merchant acquirers are well aware of their liability to reimburse the card issuer section 75 and chargeback claims, and will often hold back money from retailers to cover this liability.

2.106 In practice, voluntary chargeback arrangements are central to the protections available to consumers on retailer insolvency, and we return to this issue in Chapter 5. In Chapter 9, we make proposals to increase the transparency of chargeback arrangements.

[69] This term is explained in Chapter 5 at para 5.5(4).

CHAPTER 3
RETAILER INSOLVENCY IN PRACTICE

3.1 The previous chapter set out the legal rules governing company insolvency. Here we illustrate how those rules work in practice. We draw on a sample of 20 well-known high street retail chains which have become insolvent since the financial crisis in 2008. Many of these retailers made headlines when they collapsed, with attention directed at the issue of consumer prepayments.

3.2 We were concerned that the outcome in these large high street insolvencies may be very different from smaller insolvencies. We therefore supplemented our sample of 20 high street retailers with a sample of smaller retailers. Members of the Institute of Chartered Accountants in England and Wales (ICAEW) identified 11 smaller retailers for us: each had fewer than ten outlets and owed money to consumers on insolvency. We are very grateful to the ICAEW for their help.

3.3 We start by describing our samples. We then look at the outcome of the insolvency procedures for all classes of creditor, including preferential, secured and unsecured creditors. Generally, any return to unsecured creditors was negligible.

3.4 Next, we consider ways in which prepaying consumers may receive some protection or remedy other than through the dividend to unsecured creditors. We focus on the two predominant types of prepayments arising from retailer insolvencies: gift vouchers and deposits in the furniture/home improvement sectors. Finally, we note two general themes: under-claiming and lack of information available to consumers.

THE SAMPLES

The large retailers

3.5 The large retailers we consider are listed in Table 1. They were all well-known brands where issues of consumer prepayments had been raised in the press. Although the dates of administration range from 2008 to 2014, the majority of companies (14) entered administration between 2011 and 2013. It is often suggested that retailers tend to enter administration either just before Christmas or just after Christmas. This is an exaggeration, but there does appear to be some seasonal pattern. Out of our sample of 20, nine entered administration in the first quarter (January to March) and six in the final quarter (October to December). Only four entered administration in the second quarter and one in the third.

3.6 Two sectors stand out: furniture (including home improvement, kitchens, bathrooms and soft furnishings) and entertainment (books, music, videos or computer games). Out of the 20 large retailers in the sample, eight were in the furniture sector and five were in the entertainment sector. As we shall see, furniture retailers rely on particularly high levels of prepayments, while entertainment is attractive to those buying gift vouchers. Four retailers sold clothing or sports goods. This leaves three others: Comet (selling white goods and other electrical items); Jessops (cameras); and Woolworths (general).

Table 1: Sample of high street insolvencies (2008 – 2014)

	Company number	Date of administration	Insolvency practitioners' firm	Type of retailer
MFI	05789188	26 November 2008	MCR	Furniture etc
Woolworths	00104206	27 November 2008	Deloitte	General
Zavvi	02224492	24 December 2008	EY	Entertainment
Land of Leather	02855433	12 January 2009	Deloitte	Furniture etc
Borders	01580771	26 November 2009	MCR	Entertainment
Focus DIY	01779190	5 May 2011	EY	Furniture etc
Habitat	00548030	24 June 2011	Zolfo Cooper	Furniture etc
Homeform	06132417	6 July 2011	Deloitte	Furniture etc
La Senza	02924472	9 January 2012	KPMG	Clothing
Peacocks	00290792	19 January 2012	KPMG	Clothing
Game	01937170	26 March 2012	PwC	Entertainment
JJB Sports	01024895	1 October 2012	KPMG	Clothing/sports
Comet	00278576	2 November 2012	Deloitte	White goods
Jessops	01097345	9 January 2013	PwC	Cameras
HMV	00229249	15 January 2013	Deloitte	Entertainment
Blockbuster	02111417	16 January 2013	Deloitte	Entertainment
Republic	02025406	13 February 2013	EY	Clothing
Dreams	02189427	5 March 2013	EY	Furniture etc
Dwell	04434625	25 June 2013	Duff & Phelps	Furniture etc
Paul Simon	02815748	2 April 2014	Deloitte	Soft furnishings

The small retailers

3.7 A list of smaller retailers is provided in Table 2 below. These retailers also reflect a preponderance of furniture retailers. Six of the eleven firms were in the furniture, furnishings and interior design sector. Of the remaining five, two sold kitchen appliances; two giftware; and one wines and spirits.

3.8 Not all of these firms went into administration; four went directly into creditors' voluntary liquidation. Firms may enter liquidation immediately, instead of first entering administration, in cases where there is little chance of selling the business.

Table 2: Sample of small retailer insolvencies (2008 – 2015)

	Company number	Date of insolvency	Insolvency practitioner's firm	Type of retailer
Wrap-It	03929052	04 August 2008	KPMG	Online wedding list service
First Quench Retailing	00030129	29 October 2009	KPMG	Wines and spirits
Oceans International	05136621	08 February 2011	Begbies Traynor	Outdoor furniture
Foster Design	04588587	28 November 2011*	M1 Insolvency	Interior design
Past Times	05607298	16 January 2012	KPMG	Giftware
Lusso	07412121	27 June 2013*	M1 Insolvency	Kitchen appliances
Collectables Retail	06450629	25 September 2013	KPMG	Giftware and furniture
Broadview Blinds	01431212	13 December 2013	Begbies Traynor	Blinds and awnings
Underwood Retail	05276754	28 February 2014	Begbies Traynor	Fitted kitchens
De Dietrich Kitchen Appliances	01491005	11 August 2014*	James Crowper Kreston	White goods
Bob Hughes	01124398	30 January 2015*	Begbies Traynor	Carpeting

* Creditors' voluntary liquidation

Sources of data

3.9 The quantitative information on which we have based our analysis is publicly available, in the form of the directors' statement of affairs, administrators' proposals to creditors, and the progress reports of the administrators and liquidators.[1] These documents can be purchased from Companies House using the company number provided for each company in the tables above.

3.10 Although these documents are required by statute, they should be treated with caution. First, the figures may not be accurate. Directors' statements of affairs, in particular, are produced at a time of acute financial crisis on the basis of the information that directors are able to provide; the value of assets may be overstated and the extent of liabilities underestimated.

[1] These are documents which must be produced under the Insolvency Act 1986 and the Insolvency Rules 1986: directors' statement of affairs (Insolvency Act 1986, para 47 of sch B1); administrators' proposals (Insolvency Act 1986, para 49 of sch B1); administrators' and liquidators' progress reports (Insolvency Rules 1986, rr 2.47, 2.110, 4.49B and 4.49C).

3.11 Secondly, the documents are not presented in a standard format and, beyond certain obligatory information, do not necessarily contain the same level of detail. For example, some progress reports identify and value the claims of different groups of unsecured creditors (consumers, trade creditors, landlords and others) whereas others provide a single figure for all unsecured creditors. Sometimes, administrators state the total number of gift card holders, or the value of customer deposits, but in other cases this information is not explicitly given. Some documents list the retailer's total chargeback liability, and others do not.

3.12 In some cases, the relevant companies are still in administration or liquidation and therefore the outcome we identify may not be the final position. We set out the position as we understand it at April 2015.

3.13 We have supplemented this data with anecdotal and qualitative evidence obtained from our discussions with insolvency practitioners from the "big 4" accountancy firms – Deloitte, EY, KPMG and PwC. Together, these four firms acted in 16 of the 20 high street insolvencies we consider here, and several of the smaller ones. We are very grateful to all those who talked to us about their experiences.

THE EFFECT OF THE STATUTORY HIERARCHY

3.14 In Chapter 2 we explained that, on liquidation, a company's assets are realised and distributed to creditors in accordance with a statutory hierarchy. There are rarely enough assets to meet all the claims: instead the money runs out before the secured creditors have been paid in full. From our analysis of retailer insolvencies, we draw the following broad conclusions:

(1) Claims of preferential creditors represent a very low proportion of total liabilities; and these claims are typically paid in full.

(2) The average return to secured creditors was between 30% and 40%.

(3) Unsecured creditors, including consumers, typically received a dividend of less than one penny in the pound.

Preferential creditors

3.15 We explained in Chapter 2 that preferential claims are now effectively restricted to pension contributions, employees' holiday pay and some arrears of wages.[2] In the high street insolvencies we looked at, all these claims were met in full.

3.16 However, preferential claims were for relatively small amounts. The low value of preferential claims compared to secured and unsecured claims can be seen from the examples given in Table 3 below. In each case, preferential claims represented less than 1% of all claims.

[2] See from para 2.39.

3.17 In the case of Borders, there were no preferential claims because the administrators took the decision to pay all wage arrears and outstanding holiday pay during the administration. In cases such as Game and Dwell, the volume of preferential creditors was reduced because some of the business was sold and employees transferred over to the relevant purchaser's employment; preferential claims related only to employees working at stores which were closed.

Table 3: Value of preferential claims in retailer insolvencies

	Preferential claims (£m)	Secured claims (£m)	Unsecured claims (£m)	Preferential claims as % of all claims
MFI	**0.45**	48.0	27.8	0.59%
Woolworths	**4.61**	333.5	699.0	0.44%
Focus DIY	**1.50**	154.0	650.0	0.19%
Peacocks	**0.20**	134.0	120.0	0.08%
Dreams	**0.10**	69.3	72.4	0.07%
Game	**0.05**	61.0	179.0	0.02%
Borders	**0**	14.5	40.8	0.00%

3.18 In the smaller company insolvencies, most of the preferential claims were also paid in full.[3]

Secured creditors

3.19 As discussed in Chapter 2, secured creditors are those who have registered fixed or floating charges against the company. Although the legal effect of fixed and floating charges differs, in practice lenders (usually banks or other finance providers) register a combination of both fixed and floating charges. The information available in statutory reports tends to look at both together.

3.20 Sometimes there are several secured creditors; this was the case in at least four of the insolvencies in our sample. The terms of their security will determine the order in which they are to be paid and, in some cases, the first-ranking secured creditor may be paid in full and subsequent secured creditors may recover only in part.

High street insolvencies

3.21 Of the 20 high street insolvencies we looked at, 17 had secured creditors such as banks or investment firms. The remaining three cases (Land of Leather, Zavvi and Blockbuster) had no secured creditors, as a result of complex corporate structures, debt being held elsewhere, and unsecured intra-group loans.

[3] In the case of Wrapit, the assets were insufficient to allow any distribution at all, including to the preferential creditors: Wrapit, *Report to Creditors* (24 July 2009) paras 4.6 to 4.8.

3.22 Our analysis suggests that first-ranked secured creditors will almost always receive some form of dividend, but the level of return varies. A rough estimate based on our sample suggests that secured creditors involved in these high street insolvencies received an average of 30 to 40% of the value of their claims.[4]

3.23 The returns to the secured creditors are shown in Figure 1 below. In four of the 20 high street cases (Woolworths, La Senza, Focus DIY and Dwell), it appears that the first-ranking secured creditors received 100% of their claim. However, it should be noted that not all the second-ranking secured creditors in these cases received the full amount owed to them. In Focus DIY, for example, the second-ranking creditor received only 22% of their claim.

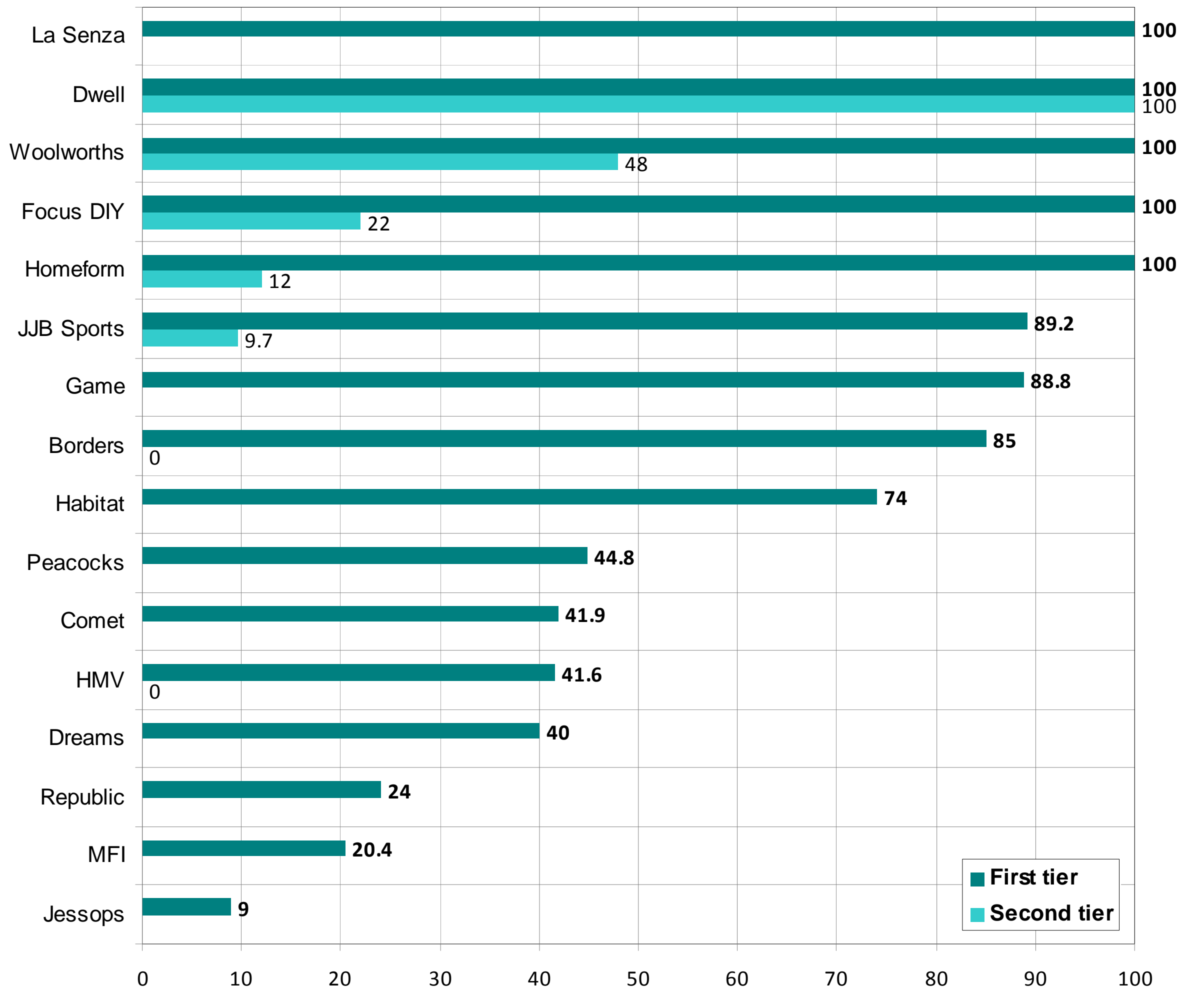
3.24 At the other end of the scale, the secured creditors of Jessops ultimately received a return of approximately 9%. The position of Jessops was particularly difficult due to the extent of suppliers' retention of title (RoT) claims, resulting in the realisation of a mere £7.4 million of assets to satisfy secured claims of £29.6 million and unsecured claims of £114.8m.

3.25 In some cases, particularly where a group of companies had become insolvent, the matter was complicated by intra-group liabilities. In the case of La Senza, all the companies in the La Senza corporate group were jointly and severally liable for the secured creditors' claims. Much of this debt was repaid by La Senza Limited, the trading arm of the group whose insolvency we analysed. La Senza Limited claimed contributions from the other group companies but received only a very small payment in return.[5]

[4] In a report prepared for the Insolvency Service in 2006, the average return to secured creditors in 431 administration procedures commenced after the Enterprise Act 2002 was found to be 42.7%: S Frisby for the Insolvency Service, *Report on Insolvency Outcomes* (June 2006) p 44.

[5] La Senza Limited recovered only £2,582 from other group companies in respect of an unsecured claim of £56.6 million (0.00004 pence in the pound).

Figure 1: Return to secured creditors in high street insolvencies[6]



Smaller insolvencies

3.26 The position for small insolvencies was similar. Out of our 11 cases, nine retailers had secured creditors. The average recovery for these secured creditors also appeared to be around 40%. In three of the 11 cases, secured creditors received between 90% and 100% of their claim, whereas in another three they received 5% or less. In the case of Wrapit, an online wedding list service, there were no funds available for any class of creditor.

Unsecured creditors

3.27 As discussed in Chapter 2, all other creditors are ranked equally. The category of unsecured creditors is wide and typically covers, in addition to consumers, suppliers, utility companies, landlords and tax authorities. Unsecured claims can be substantial. In the 20 high street insolvencies, the value of unsecured claims varied between £11.1 million (Dwell) and £699 million (Woolworths).[7]

[6] We have not included Paul Simon in this graph as the company is still in administration and the secured creditor has not yet received a final distribution. As of March 2015, the secured creditor had received £400,000 under its fixed charge, but a further distribution is anticipated: Paul Simon, *Administrators' progress report* (2 March 2015) p 9.

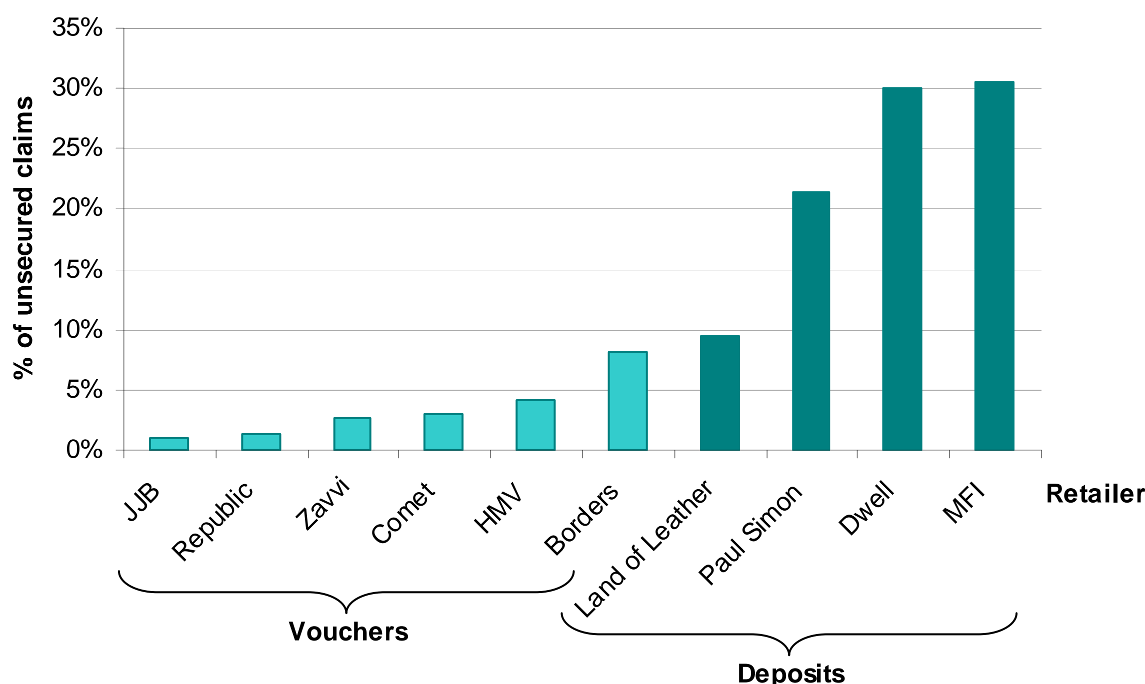
[7] The value of unsecured claims in the Woolworths case was high due to the presence of significant intra-group loans.

The value of consumer claims

3.28 Where possible, we collected data on the value of consumer claims, but in some cases these figures cannot be separated from other unsecured creditors. We illustrate some of these figures in Figure 2.

3.29 Where consumer claims relate primarily to gift vouchers, they formed only a small proportion of all unsecured claims – typically between 1 and 8% (as in the case of Comet, HMV and Borders). In the furniture sector, where more prepayments took the form of deposits, the percentage was higher: from 9.5% in Land of Leather to 30% in Dwell and MFI. This reflects the reliance furniture retailers place on consumer deposits as a source of working capital.

Figure 2: Percentage of unsecured claims relating to consumers



3.30 Some retailers had different types of consumer claims. In Comet, for example, vouchers accounted for £4.7 million, customer deposits for £2.4 million and other such consumer claims such as returns, repairs and software support for £3.9 million.

Dividend to unsecured creditors

3.31 Where the retailer had no secured creditors, the unsecured creditors received a non-negligible 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).

3.32 Out of the 17 cases with secured creditors, there was one insolvency where all secured creditors were paid in full, with some assets left over for unsecured creditors: the liquidators expected unsecured creditors of La Senza to receive between 8 and 11 pence in the pound.

3.33 In all other cases, there were no remaining assets available for distribution to unsecured creditors apart from the prescribed part (discussed below). This resulted in negligible dividends to unsecured creditors of less than one penny in the pound. In many cases, there was no dividend for these creditors at all.

The prescribed part

3.34 As discussed in Chapter 2, where the company has granted one or more floating charges, a statutory sum – the "prescribed part" – is deducted from the funds available to floating charge holders for the benefit of the unsecured creditors.[8] This is calculated according to a statutory formula and capped at £600,000.[9] The costs of distributing the prescribed part to unsecured creditors are deducted from this amount.

3.35 A prescribed part of £600,000 was distributed among unsecured creditors in insolvencies including Peacocks, Comet, HMV and Focus DIY.[10] 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.

3.36 The costs of distributing the prescribed part tend to be high. In Peacocks, the costs associated with distribution of the prescribed part were £199,000, effectively reducing it to £401,000. Distribution of the prescribed part in that case involved 18,653 different unsecured creditors.

3.37 The prescribed part can be disapplied by the administrators on application to the court.[11] This occurs where the there are very many unsecured creditors, so that each creditor's share would be minimal and the administrative burden and costs significant. Of the cases in our sample, the prescribed part was disapplied in Woolworths, MFI and Borders. There was therefore no return to unsecured creditors.

3.38 Even where the prescribed part is distributed, the sums are so small that they are unlikely to make a difference to any single creditor. For example, in the case of JJB Sports, the costs of distributing the prescribed part were £150,000, and resulted in a dividend of 0.34 pence in the pound. This would mean that a consumer with a £100 claim would receive 34p; a trade creditor with a £10,000 claim would receive £34, and a large supplier with a £100,000 claim would receive £340.

[8] We discuss the prescribed part from para 2.51.

[9] The Insolvency Act 1986 (Prescribed Part) Order 2003, s 3. See also para 2.51.

[10] The value of the prescribed part depends on the company's "net property", ie the assets available to floating charge holders, see para 2.51. It will not always reach the statutory cap of £600,000: in Habitat, the prescribed part was £165,000 and in Jessops, £197,000.

[11] Insolvency Act 1986, s 176A(5). See also para 2.54.

3.39 The operation of the prescribed part is outside our terms of reference, but these figures raise questions about whether it is achieving its objective. There appears to be a case to review it, either to raise the limits or abolish it altogether.[12]

Conclusion

3.40 Despite the complexity of the figures, the overall message is clear. The great majority of retailers have secured creditors. Returns to these secured creditors will all but exhaust the available assets, leaving only negligible sums for unsecured creditors. If consumers have to rely on receiving a dividend as unsecured creditors, often the return will barely cover the cost of applying for it.

3.41 In the rest of this chapter, we look at other ways in which consumers may receive some protection.

USE OF TRUSTS

3.42 Chapter 2 discusses how trusts may be used to protect consumer prepayments by keeping them out of the company's general asset pool.

3.43 None of the high street retailers we looked at used trusts to protect consumer prepayments in the ordinary course of business. However, in a few cases, the directors set up a trust in the last days or weeks of trading due to concerns about insolvency.

3.44 For example, the directors of Zavvi set up a trust for the proceeds of sales of vouchers one month before entering administration. Trust fund beneficiaries received a full refund whereas unsecured creditors received 25.9 pence in the pound, just over a quarter of the value of the voucher.[13] Three weeks before entering administration, the directors of Land of Leather also established a trust for consumer deposits. £957,000 was held on trust, of which £147,000 was claimed by, and distributed to, customers whose orders had not been fulfilled.

3.45 In some cases, trusts were set up for beneficiaries other than consumers. Game, for example, had established trusts for monies owed to employees, suppliers and HMRC.

3.46 In Chapter 2, we noted that trusts which are not properly created may be challenged by administrators and fail. This was the case for one of the smaller retailers, 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. There was no dividend to unsecured creditors.

[12] 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, http://webarchive.nationalarchives.gov.uk/20080610162544/http:/www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/EA02CorporateInsolvencyReport.pdf.

[13] Zavvi gift cards had a two year expiry date. After this period had passed, the unclaimed funds held on trust were released to the administrators (on application to the court) and made available to the general body of creditors: Zavvi, *Liquidators' Report* (24 January 2011) p 4.

THE DECISION TO TRADE IN ADMINISTRATION

3.47 In some cases, the sale of the business has already been agreed before a business enters administration (known as a "pre-pack"). We identified four pre-packs in our sample of high street insolvencies. In these cases, the issue of trading in administration does not arise.

3.48 In other cases, one of the first decisions the newly appointed administrator has to make is whether to trade in administration. At least 13 of the 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.

3.49 There are two main reasons for continuing to trade: to find a buyer or to sell existing stock. Administrators told us that a company which is still trading looks more attractive to potential buyers of the business and maintains the value of the brand.

3.50 Alternatively, where no purchaser can be found but the company holds sufficient stock, the administrators may adopt a "trade-out strategy" to sell the remaining stock. For example, Woolworths and Comet, which went into administration in November 2008 and November 2012 respectively, both continued to trade for around two months in order to benefit from pre-Christmas sales. Similarly, in Focus DIY, much of the stock was of a relatively high value, so continuing to trade in administration was profitable. Administrators also told us about the discount store TJ Hughes (which is not in our sample). Although the products were of lower value, quick and profitable sales of goods were made by discounting products and attracting customers into the store.

3.51 By contrast, Jessops could not continue to trade in administration due to suppliers' retention of title claims over the stock.

GIFT VOUCHERS

3.52 Gift vouchers may take several forms: electronic cards, paper-based tokens or digital codes. Here, we refer to all three as "vouchers". As we discuss in more detail in Chapter 7, gift vouchers are important to the retail sector. They were an issue in 15 of the 20 high street insolvencies we look at. Although the holder of a gift voucher has only an unsecured claim, vouchers may be honoured by administrators or by subsequent purchasers. Here, we describe the way these decisions are made and then outline the outcome for consumers.

3.53 As we saw in Chapter 2, administrators are under no obligation to allow redemption of gift vouchers; indeed they are not allowed to do so if it would damage the interests of creditors as a whole. However, in some cases, administrators may decide to trade in administration and then, if such trading occurs, to accept gift vouchers during this period.

The decision to accept gift vouchers

3.54 Administrators told us that, on appointment, the decision whether to honour gift vouchers was one of the many difficult issues they faced. They were well aware that a decision to refuse vouchers may lead to significant criticism in the press and on social media and that this could undermine the value of the brand. On the other hand, a decision to honour vouchers could be expensive: with too many vouchers and insufficient stock, the result could be a net outflow of funds, to the detriment of creditors as a whole.

3.55 Before making a decision, administrators need to look carefully at the figures, to determine the number and value of vouchers in circulation and how these relate to the stock available. This will take a few days, during which there will be uncertainty about the issue. This can cause confusion for consumers.

3.56 Administrators told us that the problem is often exacerbated by lack of information: retailers are often poor at keeping up-to-date records of gift vouchers in circulation. While a provision may be made for them in the company's accounts, this is only cursorily reviewed year-on-year. During normal trading, retailers estimate redemption rates: some vouchers will be written off on the ground that they will never be redeemed. However, these estimates may not apply during administration. Instead there may be a "bank rush": if consumers know they only have a limited time to redeem vouchers, they may dig old ones out of the bottom of drawers, resulting in a much higher redemption rate than allowed for in the company's accounts. It will be much harder for administrators to determine the maximum potential liability if the gift vouchers do not have an expiry date to serve as a cut-off point.

3.57 The next 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 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.

Reasons to honour vouchers

3.58 Administrators emphasised that the decision whether to honour gift vouchers is heavily informed by the commercial realities facing the business when it enters administration.

3.59 There are two main reasons why honouring commitments to consumers 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 (such as HMV) have a significant commercial value which can erode quickly following complaints in the press and on social media that consumers have lost out.

3.60 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 bought items of double their value.

3.61 On the other hand, honouring vouchers may be expensive, especially where stock is subject to suppliers' retention of title claims. An example illustrates a scenario where an administrator might be unlikely to allow redemption:

> A customer wishes to redeem the total value of a £100 gift card for an item costing £100 (including VAT)[14] but makes no further purchases. Title to the item has been (validly) retained by the supplier against payment of the cost price of £50. The administrator decides to allow redemption of the gift voucher during a period of trading in administration and to sell the item to the customer.
>
> Redemption of the voucher extinguishes the customer's unsecured claim of £100, but represents no cash gain for the estate. The administrator will be liable to the supplier for the sum of £50 and additionally for VAT of £16.67.[15] It has cost the administrator nearly £67 to allow the customer to redeem the gift voucher.

3.62 It may nevertheless be worth sustaining some losses to make the brand attractive to a potential purchaser, but it is unlikely that an administration could sustain losses of the magnitude just described.

Purchasers of the insolvent business

3.63 Companies buying insolvent businesses will also face decisions about whether to honour gift vouchers and/or consumer deposits on pre-ordered items. Like administrators, purchasers may also 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.

3.64 However, maintaining the value of a brand is less important where the intention is to subsume the insolvent business within 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).

[14] A VAT standard rated product sold at £100 includes VAT amounting to 20% of the pre-tax price. The product therefore costs £83.33, plus VAT of £16.67 (20% of £83.33).

[15] 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.

The outcome in the cases we looked at

3.65 Of the 20 insolvent high street retailers we looked at, the question of gift vouchers was evident in 15 cases. The value of gift vouchers in circulation ranged from several hundreds of thousands (Jessops: £870,000) to several millions (HMV: £6.5 million) of pounds.

3.66 The number of vouchers in circulation reached around half a million in some cases, including Zavvi (510,000 unredeemed vouchers with a combined value of £4.1 million) and Borders (more than 475,000 gift card holders with balances of £3.3 million). In some cases, such as La Senza, we have not been able to identify the value of the vouchers in circulation.

3.67 The following table shows the treatment of gift vouchers by administrators and/or purchasers of the fifteen retailers which had issued vouchers:

Table 4: 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 accepted in full

3.68 In seven cases, gift vouchers were accepted in full (Comet, HMV, Game, Habitat, Focus DIY, Blockbuster and Dreams).

3.69 The administrators of Blockbuster made an operational decision to continue to accept gift vouchers. This decision was taken in order to maintain goodwill and the customer base, particularly important in this case due to the loyalty of Blockbuster's customers to their local store. We were also told that the values involved were relatively low. In the case of Game, the company went into administration on a Monday, and gift vouchers were accepted from the Wednesday of that week on the basis that a sale of the business had been agreed.

3.70 HMV's administrators initially decided that gift vouchers would not be honoured. However, this decision was reversed in the wake of major media and public outcry, and gift vouchers were then accepted. The administrators emphasised that the decision was specific to this company and based on an assessment of the accounts:[16]

[16] This statement is reproduced at http://www.retailgazette.co.uk/blog/2013/01/40313-hmv-to-honour-gift-vouchers.

> The ability of administrators to honour gift vouchers will depend on the specific circumstances of each case. Since our appointment … we have been urgently assessing the companies' financial position. I am pleased to confirm that, having concluded this assessment, we are able to honour gift cards.

3.71 However, this applied only to HMV gift vouchers. Waterstones gift cards and Capital Bonds gift vouchers, which had also been redeemable in HMV, were not accepted during the period of trading in administration.

Gift vouchers accepted in part

3.72 In a further two cases, gift vouchers were partially redeemable. For example, administrators for Borders agreed to accept vouchers but required consumers to spend double the value of their gift card. This encouraged footfall in stores and meant that the funds for creditors were enhanced by the additional expenditure.

Gift vouchers not accepted

3.73 In the remaining six cases (Zavvi, Jessops, La Senza, Peacocks, Republic and JJB Sports), gift vouchers were not accepted.

3.74 Due to the organisation of assets and liabilities in Zavvi's corporate group structure, administrators could not allow redemption of vouchers because the trading arm did not own the stock. Jessops' administrators were unable to continue trading during administration, and could therefore not honour gift vouchers. This was the result of suppliers' retention of title claims over much of the stock.

3.75 Republic and JJB Sports were bought by Sports Direct, which refused to honour gift vouchers and said it was not their responsibility to do so.[17] The purchasers of La Senza (retail company Alshaya)[18] and Peacocks (Edinburgh Woollen Mill) took the same approach.

Losses to consumers

3.76 Information available in five of these cases suggests that the total value of vouchers not accepted due to the retailer's insolvency was over £7 million.[19]

[17] The Guardian reported: "Sports Direct, which bought [Republic] from administration, dashes hopes of HMV-style reprieve for out-of-pocket shoppers", http://www.theguardian.com/business/2013/apr/23/republic. While Sports Direct did not honour gift vouchers, the administrators had been able to fulfil 3,500 units of e-commerce orders, worth £0.1 million, placed prior to their appointment.

[18] La Senza entered into its second administration, under Alshaya ownership, in July 2014. We have focused on the first administration, in January 2012.

[19] Zavvi (£3.45m), JJB Sports (£1.39m), Republic (£1.2m), Jessops (£0.87m) and Peacocks (£0.75m).

3.77 The overall effect appears moderate rather than severe. In some cases the retailers had sold only a small value of vouchers. For example, in Jessops, the value of vouchers in circulation was only £870,000. In other cases, 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. According to our calculations, the average balance in the case of Borders was around £6.94 per voucher holder.

3.78 This, however, appears to relate more to chance than law. There is little to prevent severe losses to individual consumers where a retailer sells vouchers of a high value and has little free stock to trade while in administration.

DEPOSITS IN THE FURNITURE AND HOME IMPROVEMENT SECTOR

3.79 While high values held in gift vouchers are not common, deposits are more likely to be of higher value. Prepayments are a particular feature of the furniture and home improvement sector, where retailers selling furniture, fitted kitchens and bathrooms rely heavily on deposits for working capital. Goods are typically manufactured overseas (for example, in China) following an order and shipped on a just-in-time basis. The business model seems to make such firms vulnerable to financial difficulties.

3.80 In 2009, Consumer Focus commented on the series of high profile insolvencies in the furniture industry. It cited the examples of World of Leather in 2000, Courts in 2002 and MFI in 2008.[20] The analysis provided by Citizens Advice showed that similar problems may arise for retailers of kitchen appliances and other white goods. Citizens Advice identified 810 cases where consumers had prepaid for furniture, home improvement and white goods that were not delivered because the company had become insolvent. The average value was £698, but this varied from trader to trader. For one trader, the average loss was over £12,000 while for another it was £34.

3.81 Insolvencies in the furniture and home improvement sector continue to be a regular feature of the UK market place. Our high street sample included eight such retailers and the sample of smaller retailers included six.

3.82 Figure 3 illustrates the value of prepayments taken by the seven furniture and home improvement retailers in our sample for which information concerning consumer prepayments is available.

[20] Steve Brooker for Consumer Focus, *Pay now, pay later: Consumer prepayments and how to protect them* (August 2009) p 33.

Figure 3: Furniture industry – consumer prepayments to insolvent retailers

3.83 The potential for consumer detriment in this area is considerable as the sums consumers pay are significant. Below we consider how far orders were met and the protection provided by chargeback,[21] before looking at the extent of consumer losses.

Administrators' decisions to fulfil orders

3.84 Administrators told us that they would try to fulfil orders where this was feasible. The factors influencing decisions in this area are similar to those relating to gift vouchers. Administrators have to weigh the benefits of maintaining brand value against the availability of stock.

3.85 However, deposits are often more difficult to deal with. First, furniture retailers may find it more difficult to trade while in administration. Homeform did not trade in administration because merchant acquirers[22] were unwilling to provide facilities. Administrators also said that, even with funding, it would have been difficult to continue trading:[23]

> due to a high degree of uncertainty resulting from industry specific factors including the nature of the products (large items requiring deposits and fitted over the course of 6-10 weeks), requirement to ring fence deposits, potentially significant ransom payments from suppliers and fitters and other trading and property liabilities which would have required funding and/or indemnity protection.

[21] We explain chargeback in Chapter 2 from para 2.102 and in more detail in Chapter 5 from para 5.30.

[22] This term is defined at para 5.5(4).

[23] Homeform, *Administrators' statement of proposals* (17 August 2011) Appendix 1.

Similar problems applied to Dwell, which did not trade in administration; most stock held at the time of the administrator's appointment was display or damaged stock. MFI continued to trade, but this was restricted to the sale of in-store and display stock only.

3.86 Secondly, it may be difficult to convince suppliers to fulfil orders once the business has become insolvent. In some cases, the cooperation of several suppliers may be required for an order to be completed. For example, the administrators of MFI told us that the business had 1,855 suppliers and contractors; few would agree to fulfil orders without some kind of payment and a contribution to their unsecured creditor balance.

3.87 Thirdly, unlike gift vouchers, deposits relate to goods of a particular description. This means that, even if there is a period of trading, fulfilling orders presents many challenges. 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 until they have been paid.

3.88 It is usually much easier to fulfil orders subject to small deposits than those subject to larger ones. Where a prepayment is relatively small, the administrator may be able to make a profit by delivering the goods, thereby both extinguishing unsecured claims and increasing the amount of assets available to creditors as a whole. This can be illustrated with an example:

> A store is able to obtain a bed from its suppliers for £500 and sell it for £1000 plus VAT (£1,200 total). If the consumer has paid £200 in advance, it makes commercial sense for the administrator to complete the sale. The company's funds will increase even after the supplier and VAT have been paid.

3.89 However, this would not apply to large prepayments where consumers stand to lose the most:

> If, in the previous example, the consumer had paid a deposit (or deposit and subsequent instalments) of £750, then the administrator would only receive a further £450 from the consumer but would still have to pay the supplier £500 for the bed and be liable for outstanding VAT.

3.90 Administrators are highly unlikely to honour such high deposits, as it would effectively be giving stock away with no resulting return to creditors.

3.91 In some cases, the consumer may have paid the full value of the pre-ordered item – a 100% deposit. In these cases, the item would only be delivered if ownership had passed to the consumer: we outline the law on this in Chapter 2 and return to it in Chapter 13.

"Self-help"

3.92 The process of fulfilling (or not fulfilling) orders may not be as orderly as this account suggests. In some cases, consumers have simply removed the goods they think they have paid for.

3.93 Administrators still tell tales of the unrest caused by World of Leather, when stores shut their doors in the face of angry groups of consumers. One administrator told us that people falsely reported a fire in another insolvent furniture store. When staff opened the door to let in the fire brigade, consumers stormed in and took away the goods which they believed they had paid for.

3.94 The case histories provided by Citizens Advice included the following example:

> Client ordered granite sinks off Trader, purchased in full when ordered. Trader phoned client to make client aware his order had arrived in store and ready for collection... Client has been to collect today... Trader has gone into administration. Trader tried to stop Client from taking the sinks - but Client managed to remove and take home.

Merchant acquirer funding for order fulfilment

3.95 As we discuss in Chapter 5, merchant acquirers will often hold back funds ("collateral") from the retailer against potential chargeback liability.[24] The more orders that can be fulfilled, the fewer chargeback claims are likely to be raised - and fulfilling orders is often less costly than refunding deposits. In some cases, merchant acquirers decided to fund the order completion process so as to reduce the amount of money required to meet chargeback claims.

3.96 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 value of £3 million. Funding the completion of orders reduced this liability to £1.8 million.

Purchasers of the insolvent business

3.97 Some third party purchasers may undertake to fulfil customer orders. For example, the pre-pack deal for Dreams included an agreement by the purchaser to accept liability for all existing customer orders (nearly 30,000 orders, for which customers had paid deposits of about £11 million). As any remaining unsecured creditors received less than 0.1 pence in the pound, this action by the purchasers made a significant difference to the outcome for prepaying consumers.

3.98 The Homeform Group operated four key brands, one of which was sold to a purchaser which honoured the relevant customer orders. The other businesses were closed, with the result that orders were not fulfilled and consumers were left to claim as unsecured creditors.

[24] The decision of merchant acquirers to hold funds is discussed from para 5.40.

3.99 Dwell had outstanding orders of £6 million at the date of the administrators' appointment, all of which had been fully paid for. The administrators took the decision not to trade in administration due to severe problems with the supply chain. 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".[25]

3.100 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. However, the administrators of Dwell noted:[26]

> [The purchaser] wished to try and assist customers who were unable to reclaim monies owed for unfilled orders from card providers as they had purchased using cash. [The purchaser] does not, however, have a contractual or legal obligation to fulfil outstanding orders and any assistance provided will be considered a goodwill gesture.

3.101 By contrast, in Paul Simon, some of the company's assets were sold including seven of its shops. This provided continuity of employment for the relevant staff but, as the sale did not include the Paul Simon brand, the purchaser (Lewis's Home Retail) did not take liability for consumer orders or other debts of Paul Simon.

Chargeback payments

3.102 Consumers who pay deposits by debit or credit card have the ability to contact the bank which issued the card and ask for a refund. As we discuss in Chapter 5, this is an extremely important protection for consumers.

3.103 Although figures are not available for all the cases in our sample, where they are available they suggest that the amounts may be substantial. Available figures include MFI (£19.3 million); Homeform (£2.6 million); and Land of Leather (£1.1 million). Chargebacks were also important for smaller retailers: 40% of prepayments in Underwood Retail were recovered in this way and 34% in Lusso UK.

3.104 In Chapter 5, we note that consumers are not always aware of chargeback, which means that this protection is not always fully used. We make proposals and ask questions about this in Chapter 9.

Those paying by cash or cheque

3.105 In our samples, the most serious losses fell on those who were not eligible for chargeback because they used another payment method, such as cash or cheque. We have not been able to quantify these losses across the whole sample, but they are likely to be substantial.

[25] http://www.bbc.co.uk/news/business-23167752.

[26] Dwell, *Progress Report* (14 August 2013) para 5.9.

3.106 In Homeform, for example, more than 400 customers who were not eligible for chargeback claims paid deposits of more than £1.5 million. In MFI, customers who spent an estimated £8.5 million were not eligible for chargeback. These consumers lost their money.

3.107 Cash buyers may be more likely to come from lower socio-economic groups[27] and advisers reported several examples of hardship. These included an elderly man who paid £6,000 for a bathroom by cheque; a family on income support who paid £981 for a sofa and arm chair; and a family with a disabled child were left without the freezer they had paid for.

GENERAL THEMES

3.108 Finally, we consider two general themes which emerged from our analysis of retailer insolvencies. The first is that not all consumers who have lost a prepayment submit claims. The second is the confusion and lack of information which often surrounds retailer insolvency.

Consumer under-claiming

3.109 There are many examples of under-claiming at each stage of the process. This can be seen, for example, when retailers set up trusts. For example, Land of Leather put deposits of £957,000 into trust, but only £147,000 was claimed. In Zavvi, £450,000 was held on trust, of which only £205,651 was claimed and distributed.

3.110 Similarly, even where vouchers are accepted during a period of trading in administration, many are never redeemed. In Comet, there was thought to be £4.7 million worth of gift vouchers in circulation when the company went into administration, but only vouchers worth an estimated £1.5 million were redeemed during the period of administration. [28]

3.111 There are also examples where merchant acquirers held back more collateral to meet chargebacks than was actually claimed. For example, in Comet, £9.4 million was held back, though chargeback claims totalled only £2.1 million; in Land of Leather, £4.5 million was held back but only £1.1 million of chargeback claims were raised. The remaining sums were eventually released back to the company.

3.112 There are several possible causes for these discrepancies: for example, lack of information, the hassle of making claims, and consumers' lack of confidence that anything can be done.

Lack of information

3.113 When a company enters administration, the process is often accompanied by media confusion and misinformation, as administrators come to terms with the situation and make decisions.

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

[28] Comet, *Statement of Affairs* (7 December 2012) p 12; *Final Progress Report* (9 October 2013) p 20.

3.114 This can be illustrated with the recent example of Phones 4u, which entered administration on 15 September 2014. Phones 4u did not regularly take many prepayments from customers. However, the previous week it had taken more prepayments than usual due to the upcoming release of the Apple iPhone 6.

3.115 In the days immediately after the company had entered administration, media outlets attributed the following statement to Phones 4u (emphasis added):[29]

> Any orders that have not already been dispatched will be cancelled and any payments refunded to customers. Phones 4u apologise for any inconvenience.

This statement was not published on the Phones 4u website. Its origin is not clear but it seems unlikely that it was drafted or approved by the administrators.

3.116 The website of the Guardian also suggested that a refund had been approved by the administrators (emphasis added):[30]

> **Will customers who ordered the new iPhone 6 lose their money?**
>
> No. The administrator said it was Phones 4u policy not to take money in advance for phones, but if money has been paid the company has pledged to refund customers in full.

[29] See, for example, http://www.huffingtonpost.co.uk/2014/09/15/phones-4u-iphone-6_n_5820678.html and http://m.digitalspy.co.uk/tech/news/a596707/iphone-6-pre-orders-with-phones-4u-will-be-cancelled.html.

[30] http://www.theguardian.com/business/2014/sep/15/phone-4u-to-close-q-and-a.

3.117 Subsequently, in the second week of the administration, the following announcement appeared on Phones 4u's website:

> Unfortunately we do not have any iPhone 6s therefore customers who have pre-ordered an iPhone 6 through Phones 4u will not receive their purchase. Customers who have paid using credit cards should contact their credit card company to try and seek resolution to this matter. If you are unable to obtain a refund through your credit card company and wish to register a claim, your claim (to the extent you have one) will rank as an unsecured claim in the Administration.

The Guardian reported this in a later article entitled "Phones 4u in U-turn over iPhone 6 refunds".[31]

3.118 PwC's dedicated Phones 4u webpage underlined that any payment was likely to be negligible:[32]

> Please note, given the level of secured liabilities, if there is a dividend to unsecured creditors, any payment if made at all, would not be for many months and is likely to be negligible.

3.119 On 24 September, PwC confirmed that 140 Phones 4u stores would be taken over and rebranded by Vodafone and a further 58 by EE. The iPhone 6 orders were not honoured by the purchasers, though Carphone Warehouse, one of Phones 4u's competitors, did offer to give consumers who agreed to purchase an iPhone 6 with it instead a discount to the value of the lost deposit.[33]

3.120 Another issue arises from the knock-on effects from one insolvency to others in the group. For example, when Woolworths plc went into administration, another company in the group – Flogistics Limited – had been issuing gift vouchers ("Kingfisher vouchers") which could be spent at Woolworths, B&Q and Comet. When Woolworths plc went into administration, Flogistics survived but all three stores stopped accepting the Kingfisher vouchers.[34] Flogistics itself later went into administration.

3.121 Some delay in providing information and confusion over conflicting details is inevitable in the first few weeks following an administration as administrators seek to ascertain the details of the retailer's assets and liabilities. However, our analysis found that, even months and years after the insolvency procedure has been completed, it can be very difficult to determine the final outcome for creditors.

[31] http://www.theguardian.com/business/2014/sep/26/phones-4u-iphone-6-refunds.

[32] http://www.pwc.co.uk/business-recovery/administrations/Phones4U/creditors_and_suppliers.jhtml. The administrators' progress report of 14 April 2015 notes that any dividend to unsecured creditors will likely be less than 0.4 pence in the pound.

[33] http://www.carphonewarehouse.com/wecanhelp.

[34] http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/3834336/Woolworths-vouchers-worthless.html.

3.122 However, access to information is improving, with some administrators providing an information website for interested parties. A good example is www.zavvi-info.co.uk. Deloitte also publishes FAQs for consumers on its website, as well as the information they are required to publish, such as the directors' statement of affairs and the administrators' progress reports.

CONCLUSIONS

3.123 The analysis we have conducted shows that, on retailer insolvency, preferential creditors nearly always receive full payment. Secured creditors almost always receive some sort of dividend, but often much less than the value of the secured debt. The outcome for unsecured creditors is often nearly worthless.

3.124 Consumers may be protected in other ways. For example, trust arrangements can provide considerable relief where the trust has been properly constituted. Often the administrators or incoming purchasers will elect to honour gift vouchers or to fulfil customer orders, but these decisions are made on a case by case basis and cannot be relied upon. Where consumers have paid by debit or credit card, chargeback (and, in the case of credit cards only, section 75 protection) are also of considerable benefit.

CHAPTER 4
DIRECTOR LIABILITY

4.1 A company's financial difficulties will usually have started well before a company enters administration. Administration is a difficult step for retailers, which 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.

4.2 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 might not be fulfilled or vouchers honoured.

4.3 As we have discussed, some firms put prepayments into a trust account at this stage, to protect them on insolvency.[1] However, segregating consumer prepayments in this way is not always practicable. If a retailer depends on consumer deposits to pay its bills, holding consumer payments on trust may deprive the business of working capital, causing it to enter administration even sooner.

4.4 In this chapter, we start by looking at public concern about this issue. There are three possible legal sanctions: wrongful trading, fraudulent trading and director disqualification. We explore each in turn.

CALLS FOR DIRECTORS TO BE HELD TO ACCOUNT

4.5 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.

4.6 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.

4.7 Bill Tynan, who was the Member of Parliament for Hamilton South, said in Parliament:[2]

> Is it any wonder that consumers are extremely angry and are asking how companies can get away with what they believe is tantamount to fraud?
>
> […]

[1] See from para 2.58, especially para 2.77 and following.

[2] Hansard (HC), 24 May 2000, pt 3, col 249WH to 250WH.

> 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.
>
> […]
>
> I am not suggesting any impropriety, but the Department of Trade and Industry must undertake a thorough investigation into the events surrounding the closure. There are many questions to be asked and answered.

4.8 Jimmy Hood, at the time Member of Parliament for Clydesdale, said in the same debate:[3]

> 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

4.9 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.

4.10 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.

4.11 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).[4]

4.12 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 secured creditors.

[3] Hansard (HC), 24 May 2000, pt 3, col 253WH.

[4] Indeed, Uno, the parent company of World of Leather, accepted 100% deposits.

4.13 This could give banks and other floating charge holders a perverse incentive to delay the appointment of the administrators in the hope that the retailer will obtain more prepayments from consumers before administrators are appointed. As we have seen, floating charge holders are paid before unsecured creditors, and thus benefit from any additional money taken from consumers immediately before insolvency. Insolvency practitioners told us that it would be wrong for banks and others to encourage retailers to increase deposits from consumers during this period. Often good practice would require directors to set up trust funds to protect consumers. However, as we explore below, it may be difficult to apportion blame for the challenging decisions made in the run-up to insolvency.

Concern about this issue

4.14 This issue has caused public disquiet over the years. As we have seen, 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 could be held liable.[5]

4.15 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.

4.16 Below we set out the law on wrongful trading, fraudulent trading and director disqualification and discuss the case law on this issue.

LIABILITY FOR WRONGFUL TRADING

4.17 Liability for wrongful trading is set out section 214 of the Insolvency Act 1986. It applies to directors who continued to trade when they: [6]

> knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

4.18 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.[7]

[5] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558, para 1056.

[6] Insolvency Act 1986, s 214(2)(b).

[7] Insolvency Act 1986, s 214(3).

4.19 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

4.20 Wrongful trading is not a criminal act. It is a civil claim which can currently only be brought by a liquidator, although provisions in the Small Business, Enterprise and Employment Act 2015 will also allow administrators to bring an action (and, therefore, at an earlier point in time).[8] 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.[9] Of course, more cases may have been settled, but no figures are available for settlements.

4.21 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.[10]

4.22 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. While insolvency litigation is currently exempt from the Jackson reforms (which restrict the availability of "no win, no fee" conditional fee agreements), it is not clear if, and when, this exemption will be removed.[11] Removing the exemption would further reduce the options available for funding the litigation.

4.23 We are aware of one case in which the liquidator expressed disappointment that taking deposits of up to 100% and failing to fulfil the relevant orders was not considered a matter for disqualification.[12] Creditors in that case declined to fund an action against the directors.

A difficult test to meet

4.24 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.

[8] Small Business, Enterprise and Employment Act, s 117, providing for a new section 246ZB in the Insolvency Act 1986. At the time of writing, the Act had received royal assent but this provision was not yet in force.

[9] We are grateful to the Insolvency Service for providing these figures.

[10] Farepak: review of the regulatory framework, Advice from the Office of Fair Trading (December 2006) paras 48 to 52.

[11] The Government had announced its intention to end the exemption in April 2015, but indicated on 26 February 2015 that insolvency litigation would remain exempt for the time being, http://www.parliament.uk/documents/commons-vote-office/February%202015/26%20February/16-Justice-Part2.pdf.

[12] We discuss the disqualification of directors from para 4.34 onwards.

4.25 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

4.26 Should a claim against a director for wrongful trading be successful, 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.[13]

(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.[14]

4.27 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.[15]

LIABILITY FOR FRAUDULENT TRADING

4.28 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.

4.29 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…

[13] However, a director may have directors' and officers' liability insurance, a form of professional indemnity insurance, which may include cover for wrongful trading.

[14] The Small Business, Enterprise and Employment Act 2015 provides for compensation orders in the context of director disqualification proceedings, see para 4.39 below.

[15] *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.

4.30 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 much more onerous for the liquidator to prove fraud than to meet the already difficult test set out for wrongful trading above.

4.31 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).

4.32 Here, too, the burden of proof for proving fraud is high as it must be shown, beyond reasonable doubt, that the parties involved had an intention to defraud creditors or sought to pursue a fraudulent purpose.

4.33 Liability of company officers for fraudulent trading, whether civil or criminal, does not directly assist consumers who stand to lose money as the result of retailer insolvency. It is therefore beyond the scope of our project and we do not make further comment on this.

DISQUALIFICATION PROCEEDINGS

4.34 Even if liability for wrongful or fraudulent trading cannot be made out, or the liquidator chooses not to bring an action, the court will 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.[16]

4.35 The Insolvency Service is in charge of investigating a director's conduct, and if necessary, seeking a disqualification order. It will also accept a voluntary "disqualification undertaking", which has the same effect but does not involve court proceedings.

4.36 There is no definitive list of actions 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.[17] 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 also consider other factors. The court will not look narrowly at the test for wrongful trading.[18]

[16] Company Directors Disqualification Act 1986, s 6.

[17] Mithani (ed), *Directors' Disqualification* (February 2015) p 656; *Re Bath Glass Ltd* [1988] BCLC 329, 333.

[18] *Secretary of State for Trade and Industry v Creegan* [2001] EWCA Civ 1742, [2004] BCC 835.

4.37 Between January 2011 and February 2015, 4,419 directors were disqualified. However, only a tiny proportion of these cases (18, or 0.4%) were primarily concerned with allegations of trading with knowledge of insolvency (and even here the cases do not appear to be about consumer prepayments).[19] Of the 18 cases, 16 directors gave voluntary disqualification undertakings. The court made disqualification orders against the remaining two in their absence.

4.38 It is clearly rare for the courts to find against directors on the grounds that they knowingly traded 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.

4.39 At present, disqualification proceedings do not result in compensation to consumers. However, this may change. Section 110 of the Small Business, Enterprise and Employment Act 2015 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]

Case law

4.40 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

4.41 The Secretary of State brought disqualification proceedings against five directors of the now defunct furniture retailers World of Leather and Uno (its parent company).[21]

4.42 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 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.

4.43 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.

[19] We are grateful to the Insolvency Service for providing these figures.

[20] Small Business, Enterprise and Employment Act, s 110, providing for a new section 15A in the Company Directors Disqualification Act 1986. At the time of writing, the Act had received royal assent but was not yet in force.

[21] *Re Uno plc & World of Leather plc* [2004] EWHC 933, [2006] BCC 725. Two other directors had given voluntary disqualification undertakings.

4.44 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.

4.45 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.

4.46 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.[22] He found that the directors had "gone out of their way to pursue a solution" and concluded: [23]

> 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.

Farepak

4.47 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.

4.48 Again, the Secretary of State sought disqualification orders against the directors of Farepak.[24] 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.

4.49 However, on legal advice and in the public interest, the decision was later taken to discontinue these proceedings. The judge, Mr Justice Peter Smith, recognised that those who had lost their Christmas savings had directed their frustrations at the directors and would be angry that the directors had not been held accountable. He therefore, unusually, issued a statement in open court to explain the position:[25]

> I felt strongly in this case that all the depositors would have been left with a sense of being cheated again if they did not understand why the case has collapsed against the people who have been pursued for the last five years as being the evil people who caused their losses.

[22] Above at [157].

[23] Above at [165].

[24] *Secretary of State v Fowler and others* (2012). As the proceedings were abandoned, this case was not reported.

[25] Available online at https://www.judiciary.gov.uk/judgments/farepak-judges-statement.

4.50 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".[26] 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".[27]

4.51 Although the judge did not criticise the directors, he commented that HBOS, the group's bank, had "a policy of playing hardball". 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.[28]

4.52 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, proceeded to contribute an additional £8 million. It also met its own legal fees, allowing a further £1 million to be distributed to the unsecured creditors.

4.53 Despite the judge's comments exculpating the directors, Deborah Harvey, co-founder of the Farepak Victims' Committee was reported as stating: [29]

> 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:[30]

> The directors/owners of EHR[31]/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?

[26] Above, para 19.

[27] Above, para 26.

[28] See, for example, para 22 of the judge's statement.

[29] http://www.mirror.co.uk/money/personal-finance/farepak-customers-in-8m-payout-from-lloyds-1135426.

[30] http://www.theguardian.com/money/2012/jul/06/farepak-victims-get-compensation.

[31] European Home Retail (EHR) was Farepak's parent company.

4.54 We do not think that it is helpful to blame the directors personally. However, the Farepak debacle points to weaknesses in the law. The first problem is that, as we explained in Chapter 1, savings schemes are not regulated if they promise vouchers rather than cash repayments. We consider this in Chapter 11. The second problem is that under the current insolvency regime floating charge holders benefit directly from any increased consumer deposits in the lead up to insolvency. We return to this in Chapter 12.

Other cases

4.55 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).

4.56 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".[32] However, it should be noted 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.

4.57 The Insolvency Service also announced a five-year disqualification of the two directors of Manor Furniture (Swindon) Ltd for:[33]

> 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.

4.58 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.

Conclusion

4.59 Directors have every reason to try to avoid insolvency: it is human nature that they may continue their efforts to save their companies for too long. Similarly, creditors who are about to lose money will tend to focus narrowly on getting "their money" back, often at the expense of other creditors. We do not think that it is helpful to place blame on individuals who act in this way.

4.60 However, we do think there is a case for looking hard at a system of legal rules which allows floating charge holders to benefit from additional deposits taken from consumers at a time when those "in the know" realise that contracts may not be fulfilled. In Chapter 12, we examine how this issue may be addressed.

[32] https://www.gov.uk/government/news/lift-installers-get-7-year-bans-for-accepting-customer-deposits-when-company-was-insolvent.

[33] https://www.gov.uk/government/news/furniture-retailers-get-5-year-bans-for-accepting-deposits-and-failing-to-deliver-goods.

CHAPTER 5
PREPAYMENTS BY DEBIT OR CREDIT CARD

5.1 A consumer who has paid by credit or debit card for undelivered goods or services may be able to recover money through their card issuer. Our analysis of insolvencies has shown how important this possibility is. Following a major high street collapse, card issuers often make refunds to consumers totalling several millions of pounds. Estimates put the figures at £2.58 million for Homeform; £2.1 million for Comet, and £1.1m for Land of Leather. Even in the smaller insolvencies we examined, it provided important redress for consumers.[1]

5.2 Payments by debit and credit card are now the most common form of payment.[2] Consumers use these cards in shops and online on a daily basis, but may have little idea of the complex arrangements which sit behind each transaction. In this chapter we start by explaining the "card cycle" and the various entities involved in it.

5.3 We then outline two forms of redress: the statutory scheme under section 75 of the Consumer Credit Act 1974; and the voluntary chargeback arrangements. Although chargeback can be a highly effective form of redress, there is a lack of publicly accessible information about how it works. In Chapter 9, we consider proposals to make the chargeback scheme more transparent.

5.4 In the final section of this chapter, we consider whether similar forms of redress apply to other payment methods.

THE CARD CYCLE

5.5 A typical card transaction involves five separate entities. The consumer is connected with the retailer through their card issuer, the card scheme (typically Visa or MasterCard) 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.

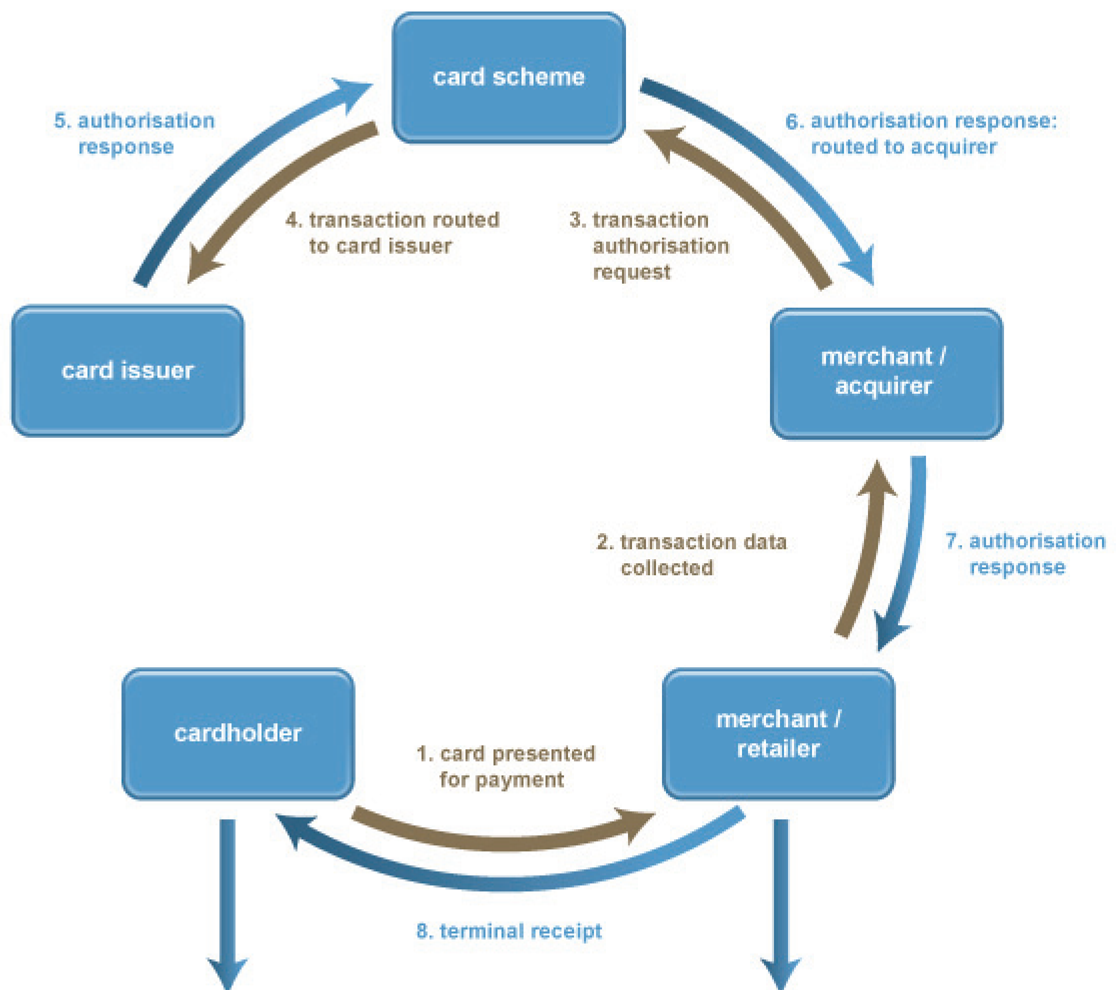
[1] See para 3.103.

[2] In February 2015, 74.5% of total retail sales were made by card, with a split of 51.0% by debit cards and 23.5% by credit cards: see UK Cards Association, *Card Expenditure Statistics* (February 2015) p 6, http://www.theukcardsassociation.org.uk/wm_documents/February%202015%20Full%20Report%281%29.pdf.

(4) The **merchant acquirer**, which contracts with the retailer (the merchant, in this terminology) 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.

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



[3] Reproduced with the kind permission of the UK Cards Association. See http://www.theukcardsassociation.org.uk/getting_started/card-payment-cycle.asp.

5.7 A consumer initiates a card transaction by inserting their card into a retailer's terminal and entering their PIN, presenting their contactless card to the terminal or entering their card details online. Details of the transaction will be passed electronically to the merchant acquirer, which will in turn direct the transaction to the appropriate card scheme (usually either Visa or MasterCard). The card scheme will then forward the transaction to the card issuer for approval. If the transaction is approved, an authorisation response will be sent back instantaneously to the retailer's terminal via the card scheme and the merchant acquirer.

5.8 The amounts owed by the 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 the contract between the retailer and the merchant acquirer. As discussed below from para 5.40 , low-risk businesses will receive funds more quickly than high-risk ones.

5.9 The payment cycle relies on a chain of legal relationships. The consumer agrees to terms and conditions which the card issuer has attached to the card. The merchant acquirer enters into a contract with the retailer to process payments. Meanwhile, the relationship between the merchant acquirer and the card issuer is governed by the "scheme rules", set by card schemes such as Visa and MasterCard. However, neither the consumer nor the retailer is a party to the scheme rules – or is necessarily even allowed to see them. In the event of retailer insolvency, the consumer has no directly enforceable contractual right under the scheme against the card issuer.

PROTECTION FOR CARD PAYMENTS

5.10 There are two main ways in which payments made 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 connected credit provider jointly and severally liable for the retailer's breach of contract and/or misrepresentation. As discussed below, this protection was primarily designed to apply to credit organised through the retailer, but it also covers credit card issuers.

(2) For all types of card transactions, including those made by debit 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 transaction made by card.

5.11 This means that a consumer who pays by credit card for a transaction worth more than £100 and less than £30,000 has a statutory right under section 75 to claim against the credit card issuer. In some circumstances, the card issuer may recoup money it has refunded to the consumer from the merchant acquirer, through the card schemes' internal chargeback arrangements. For other card payments – including all debit card payments and smaller credit card purchases – consumers have no statutory rights but they may contact their card issuer to request a refund through the chargeback arrangements.

5.12 We start by describing section 75. We then look at how chargeback works, before comparing the two.

SECTION 75 PROTECTION

The Crowther Committee

5.13 Section 75 of the Consumer Credit Act 1974 implements a recommendation of the Committee on Consumer Credit, chaired by Lord Crowther.[1] The Crowther Committee looked at "connected credit" arrangements, where a lender provided credit to buy specific goods or services and had a connection with the supplier of those goods and services. The Committee thought that if there was any misrepresentation or breach of contract by the supplier, then both the lender and the supplier should be liable to the borrower for the breach. In most cases, the lender would pay the borrower and recover the loss from the supplier. However, if the supplier was unable to pay (for example, for reasons of insolvency), the Committee thought that the loss should fall on the lender:[2]

> In considering which two of the relatively innocent parties should bear the greater loss, it is much easier for the business creditor to do so than the individual debtor.

5.14 The first credit card in the United Kingdom was launched by Barclays in 1966; in 1971, when the Crowther Committee reported, credit cards were still a new idea. The Committee was mainly thinking in terms of credit arrangements arranged directly between retailers and finance companies. For example, where a retailer offers a finance deal (such as "pay nothing for your sofa for 2 years"), this will be a consumer credit agreement which will therefore attract section 75 protection.

5.15 However, the Committee thought that similar reasoning should apply to credit cards. The Committee commented:[3]

> There is in fact a close business relationship between an issuer and the suppliers who have agreed to accept the issuer's credit cards. The issuer, through provision of the card, swells the turnover of the supplier, and for conferring this benefit usually receives by way of discount an agreed percentage of the invoice price of the goods or services supplied. Moreover, a cardholder dealing with a reputable issuer has every reason to assume that the issuer will list only reputable suppliers.

"A like claim"

5.16 Following this recommendation, section 75(1) of the Consumer Credit Act 1974 states that for connected credit agreements, a "debtor" (here, the prepaying consumer) who has a claim against the supplier for misrepresentation or breach of contract:

> shall have a like claim against the creditor, who, with the supplier, shall accordingly be jointly and severally liable to the debtor.

[1] Report of the Committee on Consumer Credit (March 1971) Cmnd 4596, para 6.1.1.

[2] Above, para 6.1.16.

[3] Above, para 6.12.9.

5.17 The key concept here is that of "a like claim": the "creditor" (here, the credit card issuer) is responsible for the supplier's misrepresentation or breach of contract to the same extent as the supplier (here, the retailer). The liability is unlimited, and may be much greater than the amount of the credit. For example, if a consumer bought a faulty cooker which burnt down the house, and the supplier would be liable under the contract for rebuilding the house, then the lender would also be liable (jointly and severally) for the same amount.

5.18 The usual limitation periods apply. For breach of contract claims, the limitation period is generally six years in England and Wales and five years in Scotland.[4] The borrower therefore has the same time (five or six years) to claim against the lender.

Monetary limits

5.19 Section 75 protection only applies to transactions within certain monetary limits. Section 75(3)(b) states that "in so far as the claim relates to any single item to which the supplier has attached a cash price", that price must be more than £100 and not more than £30,000.

5.20 It should be noted that the monetary limits attach to the price of the goods or service, not the value of the transaction. Section 75 applies where the consumer has a made a partial credit card payment of less than £100, provided the price was more than £100. For example, where a consumer orders a £200 washing machine and puts a £50 deposit on a credit card, section 75 will operate. Following the retailer's insolvency, the credit card issuer would be liable for any losses relating to the machine.

5.21 However, the monetary limit means that section 75 does not apply to smaller purchases. For example, it would not apply to most gift cards, as they are usually for values of less than £100.

Litigation

5.22 There has been some controversy over how section 75 should apply to the modern system of credit card transactions. Initially, when Barclays launched its credit card in 1966, it acted as both card issuer (or lender) and merchant acquirer. However, as the market has developed, credit card issuers have become less closely related to suppliers. Instead of a three-party relationship (between consumer, credit card issuer and retailer), credit cards now usually operate on the basis of a "four-party transaction": the credit card issuer only deals with the retailer through a merchant acquirer.[5]

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

[5] The four parties are consumer, card issuer, merchant acquirer and retailer. Although the card scheme is also involved, the process is referred to as a "four-party transaction". Some banks, such as Barclays, do operate as both card issuer and merchant acquirer, but these arms of the business operate discretely and therefore still represent four-party transactions. Some true three-party schemes, where the issuer and acquirer is the same entity, do still operate, with examples including American Express and Diners Club.

5.23 In *OFT v Lloyds TSB Bank,* the bank argued that section 75 should not apply to four-party transactions of this sort. It also argued that the section should not apply to foreign transactions. The Court of Appeal found against the bank on both issues.[6] The bank appealed to the House of Lords on the second issue.[7]

5.24 The House of Lords also found against the bank. Lord Hope gave a strong endorsement of the policy behind section 75: banks have "broader backs", were better able to obtain redress, and consumers were entitled to trust suppliers authorised to accept cards. As he put it:[8]

> The creditor is in a better position than the debtor, in a question with a foreign supplier, to obtain redress. It is not to be assumed that the creditor will always get his money back. But, if he does not, the loss must lie with him as he has the broader back. He is in a better position, if redress is not readily obtainable, to spread the cost. He is in a better position to argue for sanctions against a supplier who is not reliable. For his part, the debtor is entitled to assume that he can trust suppliers who are authorised to accept his credit card. These considerations, which support the right of recourse in relation to tripartite arrangements, are just as powerful in the case of four-party transactions.

5.25 Trust is particularly important in the modern context due to the prevalence of online retail. We think that section 75 underpins consumer trust in this practice. Without it, consumers would be much less confident, particularly for distance sales from smaller retailers.[9]

5.26 However, some aspects of section 75 remain controversial. The Government has asked the Financial Conduct Authority to review the section, though we understand that this will not happen before 2017.

Where does the loss lie?

5.27 If the supplier is not insolvent, consumers have a choice. They may claim against the retailer – or claim against the credit card issuer and leave it to recover the money from the retailer.[10] There is no requirement for them first to have approached the retailer, though in practice the card issuer might try to insist on this if it hopes to raise a chargeback and recover the payment from the merchant acquirer.

[6] [2006] EWCA Civ 268, [2007] QB 1.

[7] [2007] UKHL 48, [2008] 1 AC 316.

[8] Above, para 13.

[9] Distance selling is defined in the Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013, reg 5. In essence it refers to organised schemes which operate without "the simultaneous physical presence of the trader and the consumer" (for example online or by telephone).

[10] See Consumer Credit Act 1974, s 75(2).

5.28 For present purposes, we concentrate on cases where the supplier is insolvent. Here the consumer's only effective recourse will be to claim against the credit card issuer, and the card issuer's claim against the retailer would be worth very little. The credit card company would be merely one unsecured creditor among many.

5.29 In insolvency cases, the loss lies initially with the credit card issuer. However, the credit card issuer is able to pass much of the loss to the merchant acquirer, through the chargeback provisions set out in the card scheme rules (as described below). In broad terms, these rules permit the card issuer to reclaim the amount of the transaction from the merchant acquirer, provided the claim is made within 120 days. However, the credit card issuer must absorb other losses, including claims for consequential loss. The credit card issuer will also bear the cost of any claim which is raised after the 120 day time limit, as claims can be made under section 75 for up to six years after the breach of contract.

CHARGEBACK

What is chargeback?

5.30 Chargeback refers to a procedure set out in the Visa and MasterCard[11] scheme rules which applies to all transactions made by credit or debit card, irrespective of the amount. It has contractual force between the card issuer and the merchant acquirer, but does not give consumers any legal rights.

5.31 Chargeback allows transactions to be reversed under specified circumstances. These may include where the cardholder falls victim to fraud,[12] where the goods are not of a satisfactory quality or, most importantly for our purposes, where the retailer fails to deliver prepaid goods or services. Card issuers tend to list all these problems under the general heading of "disputed transactions".

5.32 The European Commission has described chargeback as follows:[13]

> Chargeback is the technical term used by international card schemes to name the refunding process for a transaction carried out by card following the violation of a rule.
>
> This process takes place between two members of the card scheme, the issuer of the card and the acquirer (the merchant's bank). The final customers of these two schemes members, the cardholder for the issuer and the merchant for the acquirer, do not have any direct relationship in the chargeback process.

[11] While Visa and MasterCard dominate the credit and debit card sector in the United Kingdom, other card schemes such as Amex and Diners Club (both of which act as issuer *and* acquirer) exist and will have their own chargeback rules.

[12] We were told that there is no straightforward chargeback right for fraudulent transactions, and that the chargeback right will depend on how the transaction was undertaken. However, we were also told that a card issuer is highly likely to reimburse a cardholder in the case of fraud, even if no chargeback right is available.

[13] European Commission, *Payment card chargeback when paying over Internet*, First Sub-group meeting of the PSTDG and PSULG held on 4 July 2000, MARKT/173/2000, p 3, http://ec.europa.eu/internal_market/e-commerce/docs/chargeback_en.pdf.

5.33 In essence, chargeback is the reversal of a payment transaction. The consumer contacts the card issuer which transmits a chargeback through the card scheme to the merchant acquirer. 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.

Chargeback claims for non-delivery

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

5.35 If the card issuer accepts the consumer's request, it will credit the consumer's bank account with the amount at stake and then consider whether to recover the money from the merchant acquirer under the chargeback scheme rules. We have been told that for small amounts (under £10) the bank may decide to absorb the loss on the grounds that this is cheaper than relying on the scheme rules. However, banks can and sometimes do use the chargeback procedure whatever the sum at stake.

5.36 The scheme rules set time limits for card issuers to submit chargeback claims. The details of the time limits are confidential and differ between Visa and MasterCard. We have been told that the general rule is 120 days from the date when the consumer expected to receive the goods or service. We also understand that Visa and MasterCard both operate a longstop deadline of 540 days from the date of the transaction. We set out the rules in Appendix E.

5.37 In practice, we think consumers would be well-advised to inform their card issuer within 3 months of the expected delivery date, to give the card issuer time to evaluate the claim and complete the relevant procedures.

5.38 A technical briefing from Grant Thornton explains when the 120 days starts to run.[14] 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 date of travel.

5.39 If the merchant acquirer disputes the chargeback, the card issuer and merchant acquirer may take the matter to arbitration under the scheme rules. However, this is a private matter: neither the consumer nor the retailer is involved. We have been told that the number of arbitrations is very small compared to the number of chargeback claims.

[14] Grant Thornton, *Technical briefing, Understanding and managing merchant acquiring risk* (2008), http://www.grant-thornton.co.uk/pdf/Understanding_and_managing_merchant_acquiring_risk.pdf.

Merchant acquirers’ decisions to hold funds

5.40 The merchant acquirer will usually deduct the chargeback from the funds it releases to the retailer. However, where the retailer is insolvent, the acquirer must bear 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.[15]

5.41 We have noted that when consumers make prepayments they are unable to assess retailers’ credit risk or to take steps to mitigate it. Acquirers can and do assess this risk, and they take active steps to mitigate it. In some ways they act as proxies for consumers, taking steps for the benefit of consumers which consumers are unable to take for themselves.

5.42 We have been told that where delivery of goods is instantaneous, such as in a coffee shop, funds will not generally be held back. However, where there is a long period between payment and delivery, acquirers may hold back substantial sums. Airlines are considered particularly high-risk, as there is often a long period between booking a flight and taking it. Here the acquirer may hold back considerable collateral. When Flyglobespan entered administration, its merchant acquirer, E-Clear, was holding £35 million of collateral to satisfy potential chargeback claims.[16]

5.43 Merchant acquirers will increase the amount of collateral if the retailer appears to be experiencing financial difficulties. While this is commercially sensible, such action can exacerbate the retailer’s problems by further restricting cash flow. Retailers sometimes complain that merchant acquirers overreact, and drive businesses into the insolvency against which they seek to protect.

5.44 In our analysis, we found some 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. The remaining sums were eventually released back to the company. It is difficult to know whether these figures represent over-caution on the part of the merchant acquirer or under-claiming on the part of the consumer: there may be an element of both. As the merchant acquirer risks a large loss if it fails to retain sufficient funds, caution is a natural response.

[15] Chargeback may also be possible for other reasons, such as fraud and where goods are of unsatisfactory quality. Merchant acquirers will also take the risk of these problems into account when determining a retailer’s risk profile.

[16] The Globespan Group plc (in administration), *Joint administrators’ progress report for the six months ended 15 December 2014*, p 2, http://www.flyglobespan.com/files/media/20100610-Globespan-Group-plc/The%20Globespan%20Group%20-%20Progress%20Report%2015.12.14.pdf.

Consumers' right to complain

5.45 Consumers who are not happy with their card issuer's decision whether to operate a chargeback are entitled to raise a complaint with the Financial Ombudsman Service (FOS). The FOS was established by the Financial Services and Markets Act 2000 to consider and resolve disputes between consumers and financial institutions. It 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".[17]

5.46 In 2009, 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:[18]

> 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.

5.47 On its website, the FOS describes its current stance as follows:[19]

> We consider that, as a matter of good practice, the card issuer should attempt a chargeback if the card holder has challenged a transaction *and* - taking account of the relevant card scheme rules - there appears on the face of it to be a fair chance that a chargeback request may succeed.
>
> So we normally expect the card issuer to identify whether the potential exists for a successful chargeback request. And if so, to ensure that a request is processed in the right format and within any time limits that apply.
>
> If it does not do that, then we can consider a complaint from the card holder. And we will decide whether in our opinion the chargeback would have succeeded, if it had been properly made.

5.48 The FOS has confirmed that, in the case of retailer insolvency, it is prepared to require a card issuer to compensate a consumer if it unreasonably refused to refund money when it could have made a chargeback claim. However, the FOS will not evaluate whether the chargeback scheme itself is fair, or require compensation to be paid to consumers for cases which falls outside the scheme rules.

[17] Financial Services and Markets Act 2000, section 228.

[18] Financial Ombudsman Service, *Ombudsman News* (issue 78 July/August 2009), http://www.financial-ombudsman.org.uk/publications/ombudsman-news/78/78.htm.

[19] Financial Ombudsman Service, *Disputed Transactions, Chargebacks*, http://www.financial-ombudsman.org.uk/publications/technical_notes/disputed-transactions.htm#4.

5.49 The approach of the FOS means that chargeback arrangements in the event of retailer insolvency are not as voluntary as first appears. Consumers may contact their card issuers about many different “disputed transactions”, including fraudulent payments, faulty goods or non-delivery. The FOS requires bank or building societies to deal with disputed transactions fairly, within the terms of chargeback provisions set out in the scheme rules. If, on an insolvency, a card issuer unreasonably refuses a request which falls within the chargeback rules, the FOS will require it to compensate the consumer.

Consumers’ experiences of chargeback

5.50 The case histories provided by Citizens Advice included several cases where consumers used chargeback successfully. However, it appears that where consumers were unsuccessful, consumer advisers were unsure how to advise consumers appropriately. Two issues caused particular problems: time limits and evidence requirements.

5.51 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 banks 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.

5.52 Another problem was that consumers may be asked for written confirmation from administrators that goods would 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?

THE NEED FOR TRANSPARENCY

5.53 Card issuers, merchant acquirers and card schemes emphasised that the chargeback scheme did not concern consumers or confer rights on them. It was also emphasised that not all refunds by card issuers to consumers will involve chargeback. The issuer may be required under section 75, or may otherwise elect, to reimburse the consumer and absorb the loss in circumstances where the chargeback requirements are not met, or may simply decide not to use the chargeback. Chargeback is not necessarily, therefore, the answer to a consumer's complaint. However, in practice, the chargeback rules are crucially important in determining who does or does not get repaid following retailer insolvency. Where the consumer disputes a transaction and a chargeback claim can be made, the card issuer is highly likely to refund the consumer's claim. If the card issuer unreasonably refuses, the consumer may obtain compensation from the FOS. But if the claim falls outside the chargeback scheme rules and section 75 does not apply, the card issuer has discretion as to whether or not to issue a refund and may well refuse; where it does so, the FOS will likely reject the consumer's complaint.

5.54 Given the importance of chargeback as a consumer protection measure, both in insolvency situations and more generally, we think the scheme rules should be transparent. Chargeback acts as a powerful source of protection in many circumstances, but to benefit from it, consumers must know it exists. Even consumers who know enough to make an initial phone call to their card issuer may need more information, such as applicable time limits, to be able to use the scheme successfully.

5.55 Card issuers are likely to refund money where chargeback claims are presented to the right department in the right way. But much can go wrong. The consumer may contact the wrong department or may fail to explain the situation adequately. In some circumstances, card issuer staff may not understand fully how the time limits apply, particularly when there are long delays between the transaction and the non-delivery. We consider that consumers should be armed with sufficient knowledge to be able to pursue the matter in the face of an initial refusal by the card issuer. This information should be readily available to consumer advisers.

5.56 This suggests a need for two types of information: initial information that consumers can ask for a chargeback to be raised; and an authoritative guide about how the chargeback scheme works. We look at each in turn.

Initial information

5.57 While information about section 75 is readily available online, there is much less information about chargeback. Which?, Money Saving Expert and Citizens Advice provide helpful introductions, but information tends to be vague and unspecific, or stresses the voluntary nature of the scheme. The UK Cards Association website is an example. After explaining that section 75 only applies to credit cards, it adds:[20]

> However, some debit card issuers do offer their cardholders protection which is similar to Section 75 protection. This is ultimately a commercial decision to be made by debit card issuers – so if you require more details please contact your card company to see if they offer this.

In discussions, the UK Cards Association told us that all card issuers within the Visa or MasterCard schemes offer chargeback.[21]

5.58 Banks and building societies who issue credit and debit cards give little prominence to chargeback. Many of their websites do not mention the possibility of chargeback for non-delivery of goods and services. Information aimed at consumers is also absent from, or difficult to find on, the Visa and MasterCard websites.

5.59 Administrators are quick to inform consumers about section 75 (which results in liability for the credit card issuer), but may be less eager to mention chargeback. One administrator thought that telling consumers to ask for a chargeback could be seen as preferring one group of creditors at the expense of all creditors. The logic is that more chargeback claims will result in the merchant acquirer releasing less money back to the insolvent retailer's estate to be distributed to creditors as a whole.

Further information

5.60 Once a consumer has made initial contact with their card issuer, the success of the claim will depend on the training given to the card issuer's staff. Research for Which? suggests that staff knowledge about chargeback is variable.[22]

[20] See http://www.theukcardsassociation.org.uk/individual/consumer-credit-act.asp.

[21] The UK Cards Association also provides a guide to credit cards which mentions that chargeback extend to debit cards. It explains that the scheme's chargeback processes may differ and that there is usually a time limit of between four and six months.

[22] Which? Press Office, "Bank staff failing to explain card protection rules" (25 October 2014), https://press.which.co.uk/whichpressreleases/bank-staff-failing-to-explain-card-protection-rules/. 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.

5.61 There is no authoritative public information about the full details of the scheme. While section 75 protection is set out in statute, the scheme rules are not public documents and are only available to card issuers, merchant acquirers and the card schemes which issue them (Visa and MasterCard). At a number of meetings, we were told that the scheme rules are not necessarily made available to consumers, retailers or even administrators.[23]

5.62 We appreciate that the scheme rules themselves are complex and subject to change, and may not provide much assistance to consumers even if they were freely available. However, we think that there is certain key information which consumers should be made aware of, and which should not be subject to frequent changes. We think it would be particularly helpful if a guide explained the time limits and when they run from, and best practice over the sort of evidence which is required to support a claim.

Our understanding of the scheme

5.63 In the course of this project, Visa and MasterCard provided us with details of their rules. We set out a summary of the rules in Appendix E.

5.64 Where a consumer has paid for goods or services which are not delivered, the claim will be relatively straightforward.[24] Provided that the consumer contacts their issuing bank or building society within 120 days of the expected delivery date, it appears that a chargeback claim can, and according to the FOS should, be made.

5.65 We wished to understand how the chargeback scheme deals with a case where a consumer has bought a gift voucher by credit or debit card which becomes worthless when the retailer becomes insolvent several years later. MasterCard told us that the 120 days would not run until the consumer attempted to use the voucher. However, there may be other problems.

5.66 First, only the purchaser of the voucher could raise the claim (and not someone who received the voucher as a gift). In addition, the purchaser would need to provide documentation such as proof of the retailer's insolvency, which could be difficult. However, we were told that chargeback may well apply where the retailer who was paid was not the retailer that failed to honour the voucher. For example, if a consumer buys a voucher for a toy shop at a supermarket and the toy shop becomes insolvent, both MasterCard and Visa told us that a chargeback right would exist in this situation despite the fact that the original retailer – the supermarket – has performed its side of the bargain by providing the voucher.[25]

[23] MasterCard publishes a publicly available guide to chargeback on its website. See Appendix E, from para E.2 for further discussion.

[24] For example, where a consumer is unhappy with the quality of goods received, there is more risk of disagreement and a more subjective assessment is required.

[25] The retailer which sold the gift voucher may also assist the consumer: when HMV entered administration, Asda, which had been selling HMV gift vouchers, allowed customers to swap their HMV voucher for an Asda voucher. See http://your.asda.com/news-and-blogs/bought-a-hmv-gift-card-at-asda-we-can-help.

5.67 There may be other complexities. The FOS reports that one cardholder failed to obtain a refund for debit card payments into a retailer's Christmas savings scheme because the chargeback rules did not cover "cardholder-not-present transactions where no goods are provided".[26] The bank refused to send the consumer a copy of the rules, though the FOS did see them and confirmed that no chargeback was available in that case. We are unclear about the full implications of this case, or whether this would always be the case.

5.68 A further problem is that the time limits and other rules may be revised at any time, and there is no system for communicating these changes to the public. This might result in any guide made available to the public becoming out-of-date and therefore misleading.

INTERNATIONAL COMPARISONS

5.69 The position is similar in most EU Member States. A recent report by the European Consumer Centres Network (ECC-Net) noted that card schemes in most EU countries operate internal chargeback procedures.[27] However, ECC-Net felt that "the [card-issuing] bank doesn't inform consumers about this possibility". Furthermore consumers "must insist" to get the bank or other card issuer to handle their request:[28]

> Some respondents state that consumers may be given information by regular tellers at the bank office that the bank has no means to assist them. But later, after having submitted a written complaint to the central dispute unit of the bank, they may get their chargeback handled.

5.70 That said, the report acknowledged that a positive outcome was more likely in cases of non-delivery of goods or services than in other more subjective disputes (such as faulty or poor quality goods). For example, when airlines became insolvent, chargeback was relied on to the considerable benefit of consumers.

5.71 In most EU countries, chargeback is run by card schemes and has no statutory basis. Consumers have no legal rights against their card issuer unless credit has been extended to them.[29] However, some jurisdictions provide consumers with a statutory right to chargeback in certain circumstances, even where they have paid with a debit card.

[26] Financial Ombudsman Service, *Ombudsman News* (issue 78 July/August 2009), http://www.financial-ombudsman.org.uk/publications/ombudsman-news/78/78.htm.

[27] The European Consumer Centres' Network, *Chargeback in the EU/EEA* (February 2014), http://ec.europa.eu/consumers/ecc/docs/chargeback_report_en.pdf.

[28] Above, p 12.

[29] Article 15 of the Consumer Credit Directive 2008 gives consumers the right to claim against a creditor, but it is more restrictive than section 75 of the Consumer Credit Act 1974. Currently, article 15 is limited to "linked credit agreements", which does not extend to credit cards. Moreover, article 15 allows a consumer to pursue the creditor only if they have first sought remedies against the supplier and failed.

5.72 We were particularly interested in the statutory provision in § 74 of the Danish Payment Service and Electronic Money Act 2011.[30] It applies to any purchase of goods or services through distance sales. Where goods or services are not delivered, the payer's provider (that is, the card issuer) is legally obliged to credit the payer's account. The full provision is set out in Appendix B.

5.73 In Chapter 9, we consider whether the United Kingdom should enact legislation along similar lines to give chargeback schemes a statutory underpinning.

[30] Kindly supplied by the Danish Financial Supervisory Authority.

COMPARING SECTION 75 AND CHARGEBACK

5.74 Chargeback and section 75 greatly enhance the protection for consumers in a retailer insolvency. Where applicable, they can significantly reduce potential loss. They are summarised in Table 5 below:

Table 5: Summary of section 75 and chargeback

	Section 75 of the Consumer Credit Act 1974	**Chargeback**
Nature of right	Statutory.	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.	Amount paid by card.
Claim to be made to	Card issuer.	Card issuer.
Time limit for making a claim	Six years from the non-delivery of goods or service (five years in Scotland).	Variable, but as a rule 120 days from the date on which delivery of the goods or services was expected.
Where retailer is insolvent, the loss falls on	Card issuer (unless offset by chargeback claim against merchant acquirer).	Merchant acquirer.
Is authoritative information available to consumers?	Yes.	No.

OTHER FORMS OF PAYMENT

5.75 PayPal is an online payments system: purchases may be made either by transferring funds to a PayPal account or by using a credit or debit card to fund the PayPal purchase.[31] Consumers who pay for goods purchased on eBay or any other website through PayPal are protected by PayPal Buyer Protection. If an order does not arrive or match the description, PayPal reimburse the full cost of purchase and paid delivery costs. However, the PayPal scheme does not allow consumers who raise a chargeback with their card issuer to run a concurrent claim against PayPal or to recover twice.[32]

5.76 Some retailers currently allow consumers to pay for goods or services with their smartphone[33] and this is likely to become more and more popular. However, provided that these apps require consumers to input their debit or credit card details, it seems that chargeback protection would be available.

5.77 There is currently no protection for consumers who pay for goods or services by direct debit or direct bank transfer.[34] Although the Direct Debit Guarantee applies to payments made by direct debit, its protection is limited to errors by the retailer or the bank. It does not appear to cover non-delivery of goods or services.

CONCLUSION

5.78 Between them, section 75 and chargeback arrangements provide important consumer protection in many situations. They are particularly significant when retailers become insolvent. Without them, consumers would experience significant detriment. Although it does not afford any protection to consumers who pay by cash or cheque, chargeback means that those who have made prepayments by debit or credit card have a potential opportunity to recover the money from their card issuer.

[31] The protection does not extend to transactions where one of the following items are purchased: real estate; businesses; vehicles; custom made items; goods and services prohibited by the PayPal Acceptable Use Policy; items that violate eBay's Prohibited or Restricted Items Policy; industrial machinery used in manufacturing; items equivalent to cash (including, without limitation, gift cards); anything on eBay for which the listing does not contain a PayPal Buyer Protection message or an eBay Buyer Protection message.

[32] PayPal User Agreement for PayPal Services (last updated 24 February 2015) rules 7.7 and 7.8, https://www.paypal.com/webapps/mpp/ua/useragreement-full?locale.x=en_GB#7.

[33] Current examples include the car-booking app Uber and the restaurant Busaba Eathai which allows consumers to pay for their meals through an app.

[34] We are aware that online bank transfers are commonly accepted in other countries such as Germany. Here, the consumer is redirected from the retailer's website to their online banking portal to complete the transaction. In the United Kingdom, there is currently no protection for this kind of payments.

5.79 An important policy reason for section 75 protection is that it underpins trust. Research consistently shows that consumers in this country are keen and confident online shoppers. Compared with other EU countries, more consumers buy online in the United Kingdom, spending larger sums with a greater variety of retailers.[35] Without section 75 and chargeback arrangements, that confidence would evaporate.

5.80 Although chargeback is presented as a purely voluntary arrangement between card issuers (usually banks) and merchant acquirers, those arrangements are crucially important in deciding who does or does not get repaid following retailer insolvency. We therefore think that the chargeback schemes should be transparent, to enable all consumers to claim, not just those “in the know”. In Chapter 9, we make proposals to provide more information to consumers about the possibility of raising a chargeback claim with their card issuer, and propose more authoritative guidance on how the rules work.

5.81 The voluntary nature of chargeback means that card schemes could decide to reduce or remove the scheme at any time, without the need to consult anyone or obtain approval. This would have huge implications for consumer confidence in many sectors – from airline and concert tickets to online shopping. If this were to happen, we think that the Government would need to intervene to require banks to refund transactions, along the lines of the Danish legislation. In Chapter 9, we also ask whether chargeback should be given a statutory underpinning.

[35] Ecommerce Europe, *European B2C E-Commerce Report 2014*, “light” version available to download at https://www.ecommerce-europe.eu/website/facts-figures/light-version/download.

CHAPTER 6
SECTOR-SPECIFIC PROTECTIONS

6.1 In this chapter, we consider the ways that consumer prepayments are protected in specific sectors. We look first at voluntary consumer codes, which trade bodies develop and businesses sign up to on a voluntary basis. There is now a plethora of such codes, offering varying levels of protection, with different levels of approval, take-up and recognition. Here we distinguish between those which have independent approval and those which do not.

6.2 We then consider schemes with a mandatory element or regulatory underpinning. We focus on two sectors: prepaid funerals arrangements and travel.

6.3 We are looking specifically at prepayment protection. However, codes typically cover a variety of topics, including dispute resolution and monitoring obligations. Prepayments are simply one issue among many and other issues may well be more important to consumers. An entire code cannot be assessed by looking only at prepayment protection provisions, and nothing we say here should be taken as a wider comment on the suitability of a particular code as a whole.

A HISTORY OF CONSUMER CODES

6.4 For the last 40 years, Government policy has been to encourage industries to set up self-regulatory codes, which offer consumers greater protection than the law requires. Under the Fair Trading Act 1973, the Office of Fair Trading (OFT) was mandated to encourage the growth of trade association codes of practice. This was developed in the Enterprise Act 2002, which gave the OFT power to approve and promote consumer codes.[1]

6.5 The OFT developed a model of co-regulation, where codes were developed by trade bodies and then approved by the OFT. In 2001, the OFT set up the Consumer Code Approval Scheme (CCAS) which required codes to go through a stringent approval process. Members of trade associations whose code had been approved were then entitled to display the OFT logo. It was thought that OFT approval would give consumers confidence in the scheme and encourage them to choose code members.

[1] Fair Trading Act 1973, s 124, repealed by the Enterprise Act 2002, s 8, which gave the OFT powers to approve and promote consumer codes. Section 8 of the Enterprise Act 2002 was itself later repealed by para 63 of sch 5(2) to the Enterprise and Regulatory Reform Act 2013, as the successor to the OFT, the Competitions and Markets Authority (CMA), did not take over this role. Consumer codes are now approved by the Chartered Trading Standards Institute (CTSI), see from para 6.8 below.

6.6 In April 2013, responsibility for CCAS was transferred from the OFT to the Trading Standards Institute, known since 1 April 2015 as the Chartered Trading Standards Institute (CTSI). This followed Government criticism of the scheme. In its 2011 consultation on the consumer landscape, the Department for Businesses, Innovation and Skills had raised the following problems: [2]

(1) The approval scheme was labour-intensive and lengthy, with an average wait of two years from application to approval.

(2) Only a small number of codes had been approved (ten in the first ten years of operation).

(3) The scheme was criticised as bureaucratic and inflexible.

(4) There was a cost to the taxpayer. Accreditation was free to trade associations but the scheme cost the OFT £0.8 million a year to run.

(5) Recognition of the OFT logo and awareness of the scheme were limited.

6.7 The Government's preferred option was to stop the scheme. However, on consultation, the model of co-regulation received wide support. The Government changed its position and asked CTSI to establish a successor to the OFT's code approval scheme on a self-funding basis.

THE CONSUMER CODES APPROVAL SCHEME (CCAS)

6.8 CTSI set up the Consumer Codes Approval Board (CCAB) to govern and run the scheme. The organisation is keen to approve new codes, and aims to complete approvals within 12 to 18 months.

6.9 To obtain approval, a consumer code must be sponsored by a trade body which takes responsibility for writing its own code. CTSI is the accreditation body which sets overall standards, has oversight for all approved codes and provides quality assurance. Unlike the OFT scheme, code sponsors fund the programme through an approval fee and continuing membership fees.

Number of schemes

6.10 Most OFT codes moved across to the CTSI programme: 11 out of the 12 schemes approved by the OFT did so. The exception was the Direct Selling Association, who considered "that the costs [of code membership] outweighed the benefits".[3]

[2] Department for Business, Innovation and Skills, *Empowering and protecting consumers: consultation on institutional changes for provision of consumer information, advice, education, advocacy and enforcement* (June 2011), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31394/11-970-empowering-protecting-consumers-consultation-on-institutional-changes.pdf.

[3] Direct Selling Association, *Annual General Meeting 2013 Booklet*, http://www.dsa.org.uk/_webedit/uploaded-files/All%20Files/DSA%20-%202013%20AGM%20Booklet.pdf.

6.11 As of June 2015, there were 14 CCAS codes, to which over 27,000 member businesses have signed up voluntarily. In addition to the 11 which transferred from the OFT programme, three new codes have been approved: for the home warranty provider, Checkmate; a motor code covering Vehicle Warranty Products; and a second code for the Property Ombudsman concerning residential lettings.

6.12 The codes cover a wide range of sectors, including carpet sales, removal services, renewable energy (such as solar panels), will writers and paid-for debt collection. There are also twelve prospective codes at various points in the approval process.

Core criteria

6.13 Although the content of these codes varies greatly, accreditation by CTSI requires core criteria to be satisfied. These include (our emphasis):

(1) Addressing undesirable trade practices arising within the sector;

(2) An obligation to market and advertise clearly and truthfully;

(3) Provision of clear pre-contractual information and terms and conditions;

(4) A prohibition of high-pressure selling;

(5) Cancellation rights, guarantees and warranties;

(6) Protection of deposits or prepayments;

(7) A complaints handling mechanism; and

(8) Monitoring and enforcement criteria.

Approval

6.14 The approval process consists of two stages:

(1) Stage one approval: the code sponsor must meet the core code criteria established by CTSI and the sponsor’s members must agree to abide by the code.

(2) Stage two approval: evidence must be provided to CTSI to demonstrate the code is working well in practice.

6.15 This second stage aims to ensure that outcomes, and not just promises, are accredited. When CTSI is satisfied, permission will be granted to the code sponsors and its members to use this "Approved Code" logo:

6.16 We have not been able to locate empirical data on whether consumers recognise and understand this logo.[4]

The CTSI approach to prepayment protection

6.17 The CTSI consulted on the core code criteria in October 2012 before taking over the Consumer Code Approval Scheme in April 2013. While it did not propose to remove the requirement for prepayment protection, it did propose to accept a wider range of evidence in support of this:[5]

> It is proposed that a more pragmatic approach is taken when addressing the issue of deposit or prepayment protection, and a wider range of evidence be acceptable from code sponsors on how they meet the requirements of this criterion, taking into account sector-wide trade practices and risks. For example, it is recognised that tying up working capital can be an issue for some businesses, and may not be appropriate for all trade sectors. One option may be to limit upfront deposits to a maximum percentage of the value of the goods or services.

6.18 CTSI adopted a risk-based approach: it does not insist on deposit and prepayment protection for code members where deposits or prepayments are typically low value (less than £50), or where there is a short time between payment and delivery (less than two weeks).

6.19 CTSI recognises, however, that protection should remain robust where deposits are higher-risk (such as larger deposits or for a longer period of time). CTSI allows this to be provided for in a variety of ways, including trust accounts, insurance-backed schemes, bonds, or mutual aid cover.

[4] CTSI has told us that a small sample size YouGov survey has been conducted to establish a baseline of consumer awareness. This information will be used to target consumers through marketing and PR campaigns.

[5] Chartered Trading Standards Institute, *Consumer Codes Approval Scheme: New codes approval criteria - consultation paper* (October 2012); *Consumer Codes Approval Scheme: New codes approval criteria - Response to the consultation exercise* (February 2013), http://www.tradingstandards.gov.uk/templates/asset-relay.cfm?frmAssetFileID=28140.

Prepayment protection in CTSI codes

6.20 In Appendix C, we summarise the prepayment protection provided by CTSI codes. Several codes do not specify the form that such protection must take. Instead they allow individual members to choose one of several methods. For example, the Institute of Professional Willwriters requires members who take deposits to show they are using "one of five approved methods of pre-payment protection, such as a client account or participation in the Institute's payment protection scheme".[6]

6.21 Where a method is specified, the most common is a requirement to hold client monies in a ring-fenced trust account. However, this may not be an easy option for businesses. It requires additional administration on a day-to-day basis, results in upfront legal costs and deprives the business of working capital. As we discuss in Chapter 2, there is also a risk that trusts will be challenged by administrators and liquidators, and so fail to provide protection.

6.22 A few CTSI codes offer insurance schemes. For example, the Renewable Energy Assurance Scheme (REAL) extended the insurance arrangements it had previously used for warranties to cover deposits as well. From February 2012, the Deposit and Workmanship Warranty Insurance (DAWWI) scheme is one option available to members of the scheme who take deposits.

6.23 Some consumer codes provide for "mutual assistance". The British Association of Removers (BAR) is an example. If a member goes out of business or otherwise does not complete the service, the trade association will enlist another member business to complete the contract. BAR pointed out to us that this was usually the consumer's priority. BAR also undertakes that, if the business cancels less than 10 days before the agreed removal date, and it cannot find another member to complete the service, it will refund 150% of monies paid. Refunding more than they originally paid aims to reassure customers that they are "completely protected".

6.24 Another code sponsor, the Carpet Foundation, undertakes to fulfil orders if the consumer has paid a deposit of up to 50% of the order value.[7] This relies on the consumer paying the Carpet Foundation or the new supplier the balance of the price. The British Healthcare Trades Association runs a similar scheme, but will only absorb deposits of up to 15% of the retail price. Such order fulfilment schemes can be effective, but they rely on traders keeping deposits relatively small. This does not always happen: a failure to adhere to the maximum deposits level agreed with CTSI resulted in the Carpet Foundation being advised it was not meeting the core criteria.

[6] Chartered Trading Standards Institute, *Institute of Professional Willwriters Audit 2014*, p 5, http://www.tradingstandards.gov.uk/templates/asset-relay.cfm?frmAssetFileID=75379.

[7] Carpet Foundation, *Consumer Code of Practice for use by "retail member" retailers*, para I(3), http://www.carpetfoundation.com/wp-content/uploads/code-of-practice-updated-29.07.14-Final-Version.pdf.

Sectors not covered

6.25 Unfortunately, the current CTSI codes leave many sectors uncovered, including the furniture and glazing sectors.[8] Furthermore, the Motor Codes (New Cars) scheme applies only to the manufacturer or other warranty provider, and not the dealer. There is currently no scheme protecting deposits paid to car dealers who become insolvent.

VOLUNTARY CODES OUTSIDE OF THE CCAS

6.26 CTSI approved codes are not the only ones in the market. They compete with other types of code, including the following:

(1) TrustMark, an accreditation scheme allowing consumers to identify reliable and reputable tradespersons to carry out repair, maintenance and improvements in the home.

(2) Local authority "Buy with Confidence" schemes, which aim to identify local retailers that adhere to a certain set of minimum standards. The requirements are not as exacting as the CTSI criteria: in particular, they do not include prepayment protection.

(3) The British Standards Kitemark scheme which attests to product quality and safety, but usually refers to the product itself and does not deal with prepayment protection.

6.27 This can present consumers with a confusing array of different logos and schemes, each offering different levels of protection. CTSI has told us that one of the strategic aims for the Consumer Code Approval Scheme is to reduce confusion and it is working alongside the Department for Business, Innovation and Skills to achieve this.

PREPAYMENT PROTECTION IN OTHER CODES

6.28 Most of these codes do not provide any form of prepayment protection. Here we look at some codes in high-risk sectors which address (or try to address) the problem.

[8] Several trade bodies in this sector are currently seeking CTSI approval for their code. A list of prospective code sponsors, whose codes have not yet been approved, can be found on CTSI's website at http://www.tradingstandards.gov.uk/advice/Prospectivecodesponsors.cfm.

SafeBuy

6.29 SafeBuy is an independent standards body for online retailers, set up in 2003 after Which? closed its WebTrader scheme. Subscribers to its code of practice undertake not to accept orders which are unlikely to be fulfilled within 30 days and not to process payment from consumers more than two working days before dispatch of the goods. If they do, such payments are to be regarded as prepayments:[9]

> Deposits and prepayments must be protected against loss in the event of the retailer ceasing to trade or for any other reason. This protection must be provided by an insurance-backed scheme, a ring-fenced consumer account, independent third party holding of such funds or other secure deposit.

6.30 SafeBuy had obtained stage one approval from the OFT. It withdrew its application for full approval from CTSI in February 2014 for reasons unrelated to consumer prepayment protection.

TrustMark

6.31 TrustMark is a voluntary scheme endorsed by the Government which aims to provide consumers with additional protection across all types of building and home improvements work. It covers supply and fitting of kitchens and bathrooms but not items more usually regarded as "furniture", such as sofas.

6.32 Businesses which sign up to TrustMark must, at a minimum, provide consumers with the option of a warranty covering prepayments and rectification of defects or major damage if the business ceases to trade.[10] However, this does not necessarily have to come free of charge: consumers may be required to pay for it.

6.33 Trustmark is trying to improve protection, continuing consultation with stakeholders and Government about whether it is practical to require businesses to provide a mandatory two year guarantee. This would cover prepayments, deposits and work in progress for work valued in excess of £500, on the basis that it is to be free of charge and available for activation through an online process. This work is ongoing, taking into account developments in other Government-backed schemes and also in the insurance products that are becoming available in this market.

[9] *The SafeBuy Code of Practice*, para 4.6, http://care.safebuy.org.uk/code-of-practice/.

[10] TrustMark, *Core Criteria Document*, version 6 (2014) section 8, http://www.trustmark.org.uk/media/74165/core-criteria-artworked-may-2014.pdf.

The Furniture Ombudsman

6.34 The Furniture Ombudsman (TFO), originally called Qualitas, was established in 1992 following OFT reports noting significant consumer detriment in the furniture industry.[11] After initial enthusiasm from the industry, Qualitas found itself struggling financially. In the late 1990s, the OFT asked the Furniture Industry Research Association (FIRA) if it could house the organisation. In 2007, the organisation changed its name to the Furniture Ombudsman. In 2014, it detached itself from FIRA to become an independent not-for-profit company.

6.35 TFO's remit extends beyond furniture to the supply and installation of kitchens and bathrooms. Membership is voluntary. The scheme now has around 150 full members, covering 4,000 to 5,000 outlets plus their online sales. Members adhere to a code of practice which makes no reference to consumer prepayments.

A limited payment protection scheme to cover ombudsman awards

6.36 Alongside its code, TFO runs a limited payment protection scheme which covers six large firms among the 150 members.[12] The main aim of this scheme is to ensure that there are funds available where a dispute arises between a retailer and a customer. It responds to the criticism that consumers who provide full payment in advance have no ability to withhold funds from the retailer should there be a problem with their order. It is not therefore directed at protecting consumers in the event of retailer insolvency. However, it does aim to ensure that a consumer who is awarded compensation by TFO has that award paid, even if the firm becomes insolvent after a complaint has been lodged.

6.37 TFO administers a trust account for each of the participating retailers.[13] Initially, it took 20% of the contractual value each time a dispute was raised. However, this proved to be administratively unworkable and TFO adjusts the amount it holds for each retailer on a monthly basis, depending on the value of lodged disputes.

6.38 Based on its current caseload, it currently holds between £30,000 and £40,000 for each scheme member. TFO has yet to make any payment from the money it holds, though it may do so soon to cover an adjudication award in a case involving an insolvent member.

Application for approved CTSI consumer code

6.39 TFO is keen to organise a CTSI approved code. It has now submitted its application and is awaiting stage one approval. The submitted code is based on the existing rules for TFO membership but now also includes full prepayment protection for the consumer between the date of payment and delivery.

[11] See Office of Fair Trading, *The Protection of Consumer Prepayments* (March 1986) and *Furniture and Carpets - A report by the Director General of Fair Trading* (February 1990) pp 29 to 30.

[12] The six firms (including B&Q and Homebase) account for almost 1,200 retail stores.

[13] Holding the money on trust will protect consumers from TFO's insolvency, but not from that of retailers.

6.40 TFO proposes to allow members to offer prepayment protection in a number of ways. All pose challenges. As we saw in chapter 3, the industry often relies on deposits for working capital, so segregating funds into a trust account may not be a popular option. Providing a bond may not suffice if the retailer becomes insolvent. The insurance market is still developing so some members may find it difficult to obtain coverage. TFO is undertaking more detailed research into the availability of insurance and hopes that, even if only a proportion of the industry is covered, consumers will be in a better position by being able to choose a retailer which offers prepayment protection.

6.41 Assuming that the submitted code is approved, TFO will run two codes: the current obligatory one which does not include prepayment protection, and the new optional CTSI-approved one which does. TFO refers to the proposed set-up as "tiered membership". It is unclear how many members will be persuaded to sign up to the code with more stringent financial safeguards. Furthermore, the scheme will require careful marketing if consumers are not be confused by the fact that some retailers promoting their TFO membership may not have signed up to the more extensive code.[14]

Home improvements and the glazing sector

6.42 Developing codes has proved to be particularly problematic in the glazing and conservatory industry. It has a bewildering variety of trade associations, each with its own arrangements. A review of 21 different trade associations operating in the sector, commissioned by one of them, found that few provided adequate deposit protection.[15]

6.43 In some codes, prepayment protection is optional. In others, protection is subject to a cash limit. Furthermore, consumers may have to take steps to register for protection or the protection may be time limited. For example, the Consumer Protection Association provides payment of the lower of £7,500 or 25% of the contract price, but consumers must register for protection by recorded delivery within 7 days of paying the deposit.[16] Cover lasts for 90 days. In the GGFi scheme (the insurance arm of the Glass and Glazing Federation), some forms of deposit protection are limited to the lower of £1,000 or 10% of the contract price.[17]

[14] See, for example, *Patchett v Swimming Pool and Allied Trades Association* [2009] EWCA Civ 717 in which a trade association failed to make a clear distinction between full and associated members, with the result that a consumer wrongly thought that his contractor's work was underpinned by warranty and insurance protection in the event of the contractor's insolvency.

[15] *The Consumer Protection Report: Double Glazing and Conservatories*, commissioned by the Double Glazing and Conservatory Ombudsman Scheme (DGCOS) (3rd ed, April 2013) chapter 5, https://www.dgcos.org.uk/assets/uploads/Datasheets/Consumer_Protection_Report_3rd_edition.pdf.

[16] Consumer Protection Association brochure, *How to improve your home with complete confidence*, version 2, pp 6 and 7, www.thecpa.co.uk/wp-content/themes/twentyeleven-cpa/downloads/cpa_brochure.pdf.

[17] This is the "new company" scheme; the "main scheme" offers protection of the lesser or £6,250 or 25% of the contract value. We are grateful to the GGFi for providing us with this information.

6.44 The glazing sector highlights the problems of relying on self-regulation. Although there are some good schemes on offer, consumers can be confused by the sheer number of competing organisations and codes. Some schemes do not provide prepayment protection. In others, protection schemes may look adequate but protection is diluted in their small print, with low limits and onerous registration requirements.

The Christmas Prepayment Association

6.45 After Farepak collapsed in 2006, attention turned to similar savings schemes and the risk they presented to consumers. While there is still no statutory requirement for protection, the Department for Business, Enterprise and Regulatory Reform (BERR)[18] liaised extensively with the industry to come up with a voluntary code of practice. The result of these efforts was the establishment of the Christmas Prepayment Association (CPA), a self-regulatory trade association for the Christmas savings industry. It currently has six members who adhere to a voluntary code of practice,[19] which requires them to hold consumers' savings on trust overseen by trustees, half of whom must be independent of the member.

6.46 There are, however, several Christmas savings schemes which are not part of the CPA, particularly Christmas savings clubs run by large supermarkets and smaller retailers. We return to these in Chapter 11, making proposals and asking questions.

The Consumer Code for Home Builders

6.47 The Consumer Code for Home Builders was introduced in 2010 in response to an OFT market survey on home building.[20] It is an industry-led code of conduct for builders and aims to ensure the home buying process is fair and transparent for purchasers. It applies to home builders which are registered with the United Kingdom's main new home warranty providers and contains 19 core criteria to which builders must adhere. Like many others, this code is not exclusively aimed at protecting consumer prepayments, but rather at providing a better experience for consumers by providing information requirements and a dispute resolution mechanism.

6.48 The code requires builders to explain clearly "how home buyers' contract deposits are protected and how any other prepayments are dealt with". This requirement is supplemented by guidance to builders:[21]

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

[18] This department was superseded by the Department for Business, Innovation and Skills (BIS) in June 2009.

[19] The members are: Country Christmas Savings Ltd, Family Christmas Savings Ltd, Park Christmas Savings Ltd, Variety Christmas Savings Club Ltd, Post Office Ltd and Flexesaver Ltd. See http://www.cpa-advice.co.uk/members.htm.

[20] Office of Fair Trading, *Homebuilding in the UK: a market study* (September 2008).

[21] Consumer Code for Home Builders, (3rd ed, April 2013) para 3.4, http://consumercodeforhomebuilders.com/wp-content/uploads/2015/04/Builder-Guidance-Note-Third-Edition.pdf.

DIFFICULTIES WITH PREPAYMENT PROTECTION THROUGH VOLUNTARY CODES

6.49 Voluntary codes have long been seen as the main way of preventing detriment to prepaying consumers when a retailer becomes insolvent. In Chapter 1, we summarised OFT reports dating back to 1984 which called for "the evolutionary development" of such schemes.

6.50 In its response to the 2011 BIS consultation, the OFT reaffirmed that prepayment protection through codes was important but difficult:[22]

> This criterion is strongly supported by consumer groups and it addresses a key issue of consumer confidence, although some sponsors find it the most difficult requirement to meet.

6.51 There is no doubt that protecting prepayments can be onerous for many traders. Putting money into trust is legally and administratively burdensome, and deprives the trader of working capital. We were told that insurance arrangements can be difficult to obtain. We have been told that the market is underdeveloped; there is a lack of data on the extent of losses; and insurers may treat individual firms seeking cover with suspicion.

6.52 The requirement to protect consumer prepayments can sometimes be a deal-breaker for trade bodies. We have noted that the Direct Selling Association did not transfer to the CTSI programme. In its response to the BIS consultation, 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".[23] It noted that this requirement imposed significant costs on companies that signed up to a code which are not imposed on non-member companies.

6.53 ABTA, a trade body in the travel sector, is another example. Its consumer code was approved by the OFT in September 2005, but ABTA withdrew from the scheme in September 2006 when changes to its consumer financial protection arrangements meant consumers' money was no longer guaranteed in all cases.[24] ABTA felt that the OFT failed to allow sufficient flexibility in relatively low-risk areas which fell outside the statutory requirements. Since then, CTSI has allowed more flexibility and ABTA is now reapplying for approval of its code.

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

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

[24] For example, withdrawal of protection in the case of fraud by the retailer. See ABTA's written evidence to the Trade and Industry Select Committee (June 2007) and the Report of the Select Committee on Trade and Industry, *The work of the Office of Fair Trading* (2006-07) HC 591, Ev 38 - 40. For a discussion of the statutory arrangements, see below, para 6.60 onwards.

PREPAYMENT PROTECTION WITH A MANDATORY ELEMENT

6.54 As early as 1986, the OFT suggested that, if voluntary arrangements fail, regulators may need statutory powers to require firms to protect prepayments.[25] In this section, we consider those sectors where there is some element of compulsion.

6.55 There are many areas where businesses hold money belonging to consumers. This is common, for example, when solicitors convey houses or receive court settlements, or when financial advisers are given client money to invest. In these cases the money does not belong to the firm and it would be wholly wrong for the firm to use it as working capital. There are therefore many provisions which require firms to hold client money on trust in segregated accounts. Examples are the Financial Conduct Authority (FCA) rules, set out in the Client Asset Sourcebook (CASS); and section 13 of the Estate Agents Act 1979.

6.56 It is less common for retailers to be required by law or regulation to protect consumer prepayments. However, mandatory schemes apply to funerals and to the travel industry, as we outline below.

Prepaid funerals

6.57 Consumers may wish to pay for their funeral in advance to avoid burdening relatives with these costs when they die. The value of the prepayment may be several thousands of pounds and the time between prepayment and delivery of the funeral both long and uncertain. 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.

6.58 In essence, the provision of funeral plans is a regulated activity subject to FCA supervision.[26] 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.[27]

6.59 The Funeral Planning Authority is a self-regulatory organisation for the funeral planning sector in the United Kingdom. It requires insurance-backed protection coupled with an undertaking that another member will deliver the funeral in the case of member insolvency.

Travel

6.60 Travel is also 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 should their travel organiser collapse.

[25] Director General of Fair Trading, *The Protection of Consumer Prepayments* (March 1986).

[26] Financial Services & 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.

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

6.61 These concerns led to one of the first statutory schemes to protect consumer prepayments. From 1972, organisers who sell holidays involving air travel require 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.

6.62 This left questions about other forms of holiday, for example packages by coach, rail or sea. From the 1960s, the Federation of Tour Operators (FTO) and ABTA, both 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. The aim is to provide the means to refund prepayments and repatriate consumers in the event of insolvency.

6.63 Although the 1990 Directive does not distinguish between air and non-air holidays, the Government decided at the time to build on the schemes that were 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. The schemes have sometimes struggled to keep pace with changes brought about by online booking, where consumers increasingly put together their own packages from a series of elements selected separately.

6.64 Here we provide only a brief introduction to these complicated arrangements. A fuller explanation is given in Appendix D.

Packages involving air travel: the ATOL scheme

6.65 The ATOL scheme is administered by the Civil Aviation Authority (CAA) under the supervision of the Department for Transport (DfT).[28] From 2009 to 2013, over 100,000 people were repatriated under the ATOL scheme at a cost of £40 million, while nearly 500,000 received refunds totalling £130 million.[29]

6.66 Although new travel organisers must provide a bond, the scheme is largely financed by a levy of £2.50 per passenger, paid into the Air Travel Trust (ATT) fund. The fund has a balance of almost £55 million and there is a £300 million insurance policy to cover larger losses, as well as a £75 million overdraft facility.[30]

6.67 Since 2012, ATOL protection has extended beyond traditional packages to cover "flight-plus" arrangements, where consumers buy a flight together with either accommodation or car rental through the same organiser. However, scheduled airline flights remain largely outside the scope of ATOL – or any other sector specific protection. Here section 75 and voluntary chargeback schemes provide the only effective source of consumer protection.

[28] See from para D.23 of Appendix D.

[29] Department for Transport, *Review of Package Travel Directive and ATOL Implementation and Funding Arrangements: Call for Evidence* (May 2013) p 22.

[30] Civil Aviation Authority, *Air Travel Trust Annual Report & Accounts* (March 2014) p 11.

Packages without flights

6.68 Packages not involving air travel are subject to insolvency protection provisions of the Package Travel Regulations 1992,[31] overseen by the Department for Business, Innovation and Skills. The Regulations allow travel organisers to protect consumer prepayments in three ways: through bonding with an approved trade body; through insurance; or through trust arrangements.

6.69 In practice, the main way in which the protection is provided is through bonding with ABTA, which is described below. However, other trade bodies also run bonding schemes (such as the Confederation for Passenger Transport). Moreover, not all members of ABTA use the bonding scheme: we were told that 50 to 60 of ABTA's 800 principal members opt for insurance instead, though ABTA does not accept trust arrangements. Further, some travel organisers are not members of any trade body.

6.70 The Regulations only apply to package holidays. They do not cover cases where a travel agent supplies only accommodation, or only a coach trip, or a consumer books the different elements of their holiday separately. Here some ABTA members provide voluntary protection but they are not required to do so.

ABTA bonding

6.71 In Appendix D, we describe how the ABTA bonding arrangements work. ABTA requires new members to lodge a bond of at least £40,000 or 15% of turnover (whichever is the greater). For those with a good risk record, this will reduce to 10% - the minimum set by the Regulations – over time but will remain in place at this level. Most retailers obtain a bond from a normal business bank, though some insurance companies may also provide bonds. 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.

6.72 However, the bond may not be sufficient to cover insolvency at the height of the holiday season. ABTA therefore provides further insurance cover through its own captive insurance company. Its members pay an additional premium for this. We were told that ABTA itself also pays a premium to make sure that its insurance fund is able to respond where an ABTA member has failed to pay their premium or their bond is insufficient.

6.73 These arrangements sit alongside consumers' claims under section 75 and chargeback. In practice, ABTA will not pay claims if the consumer could also make a claim against their card issuer. ABTA may require the consumer to provide copies of correspondence with their card issuer before a claim is honoured.

Comment

6.74 The travel industry has long-standing and elaborate arrangements in place to protect consumer prepayments. We were told that these work in the vast majority of cases ("99% of the time").

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

6.75 However, there are major challenges. First, as consumers increasingly buy elements of their holidays separately online, they may fail to understand what is or is not protected. They may not be aware, for example, that accommodation-only bookings are not protected. Secondly, there is the need to ensure that package providers who are not members of a trade body actually have the necessary arrangements in place. There are also challenges in ensuring that the financial arrangements can cover the shock of a major organiser failing at peak season. It was suggested that even ATOL's indemnity fund with insurance cover may not be sufficient if the very biggest organiser failed at the wrong time.

6.76 In this project, we are not looking in detail at these issues. We are aware that the Package Travel Directive is being reviewed at EU level,[32] and that the Department for Transport is consulting on the ATOL scheme. We do not think we can add to these discussions. Instead, we have looked at the travel arrangements to see what lessons they may provide to other industries.

6.77 First, the travel sector illustrates some of the complexities of keeping sector-specific schemes up-to-date as new ways of doing business emerge. It also illustrates the central importance of section 75 and chargeback arrangements, even in this regulated area. They are consumers' only protection when booking flights or hotels separately – and are effectively the first port of call when package holiday providers become insolvent. Finally, we were interested to see how difficult it has been to establish a private insurance market in this area: less than 10% of ABTA members by number are protected by insurance rather than bonding; in terms of the total value protected by insurance, this figure is even smaller. We return to the difficulties of insurance arrangements in Chapter 10.

CONCLUSION

6.78 For many years, Government policy has been to address problems with prepayments on a sector-specific basis, often through voluntary codes. For example, following the Farepak collapse, BERR urged the Christmas savings industry to establish the Christmas Prepayment Association (CPA).

6.79 Consumer codes ameliorate problems associated with consumer prepayments in many sectors. They have been particularly successful for industries that typically take only small deposits, and where other suppliers are able to step in to fulfil orders. An example would be the approach of the British Association of Removers (BAR). The point was also put to us that "something is better than nothing". A scheme which solves 50% of problems is better than no scheme at all.

6.80 That said, consumer codes suffer from several problems. First, the reliance on voluntary action means codes attract the good firms; businesses with a poor track record of consumer protection do not sign up, or may leave when problems start. This makes the raising of standards across the sector difficult.

[32] As at 5 June 2015, the European Council and Parliament had reached political agreement on the text of the revised Package Travel Directive. The document 8969/2015 is available on the website of the European Council under institutional file 2013/0246 (COD). The provisions on package organiser insolvency, set out in articles 15 and 16 of the revised directive, are significantly more elaborate than those in article 7 of the current Package Travel Directive.

6.81 Secondly, there is the proliferation problem. As consumers are faced with more and more schemes and logos, they may have little idea of the protection each offers. They may find it difficult to recognise different schemes and to differentiate between them. Retailers may find that signing up to a good scheme offers no greater marketing advantage than signing up to one which imposes minimal requirements. Why meet onerous requirements at substantial cost, when consumers may be equally impressed by the eye-catching logo of a much less demanding scheme?

6.82 Thirdly, prepayment protection is often particularly onerous for retailers. Putting money into a trust account deprives the business of working capital, and is legally and administratively burdensome. Although insurance schemes exist in some sectors, we have been told that the insurance market for consumer prepayments is underdeveloped. Without historical loss data, only a few insurers are willing to offer such insurance. It is often difficult to obtain, expensive and hedged with exclusions and conditions. Meanwhile, bonding is unlikely to provide sufficient cover on its own: the ABTA approach shows that it needs to operate in conjunction with an insurance scheme, which again may be difficult to organise.

6.83 In Chapter 3, we identified particular problems with the furniture and home improvement sector. In this area, it has proved to be particularly difficult to solve problems through voluntary codes. In its 1990 report on furniture and carpets, the OFT said that retailers "should take steps to establish and publicise prepayment protection schemes to safeguard consumers' interests" and indicate the steps they proposed to take to establish such schemes within six months.[33] Twenty-five years later, the furniture industry continues to have no protection in place for consumer prepayments.

6.84 Given the varying levels of protection for prepayments, it is often difficult for consumers to determine whether they are covered, to what extent, in which circumstances and whether there is a back-up plan in case of insolvency. This is especially true in the glazing sector, when there is a wide range of competing schemes, many subject to low cash limits and onerous conditions. There is a risk that consumers mistakenly think they are fully protected when they are not.

6.85 As a general approach, the Law Commission welcomes voluntary codes, but only in addition to an adequate minimum level of legal protection. In Chapter 11, we consider whether there is a need for sector-specific regulation and in Chapter 12, we propose a limited change to the statutory hierarchy of creditors' claims on insolvency.

[33] Office of Fair Trading, *Furniture and Carpets: A report by the Director of Fair Trading* (February 1990) para 5.9.

CHAPTER 7
GIFT CARDS AND VOUCHERS

7.1 Gift vouchers first became available in 1932 with the launch of National Book Tokens. The United Kingdom now has one of the most developed gift card and voucher markets in Europe, worth £5.4 billion per year.[1] It is, however, varied and complex.

7.2 In this chapter we outline some of this variety. We explain that some types of gift card are regulated under the Electronic Money Regulations 2011 (EMR 2011), but the majority are not. We consider how far confidence in the sector is affected when retailers and organisations which have received payment for cards and vouchers become insolvent.

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

THE BENEFITS OF GIFT VOUCHERS

7.4 Both the purchaser of a gift voucher and its final recipient may value the freedom it provides. They allow the recipient to choose their own present but are more personal than cash.

7.5 For retailers, they provide three benefits, over and above an equivalent sale of goods or services. Vouchers act:

(1) *As promotion*. Vouchers bring consumers into the store. Retailers benefit from the "up-spend", when recipients spend more than the value of the voucher.

(2) *As working capital*. When buying a voucher, the consumer effectively makes an interest-free loan to the business. This may provide an important source of working capital. As the retailer Game put it in its 2014 annual report:[2]

> Our gift cards, deposits and trade-ins for credit provide us with additional working capital which assists us in seeking to compete effectively on price.

[1] Of this £5.4 billion, vouchers purchased directly by consumers account for 50% of sales. The remainder is made up of "business-to-business" (B2B) market, explained below at paras 7.11 to 7.13. UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf.

[2] GAME Digital plc, *Annual Report and Accounts 2014*, p 37, http://www.gamedigitalplc.com/~/media/Files/G/Game-Corp/documents/year-in-review-2014/game-ar2014-dr-final.pdf.

(3) *As profit when vouchers are not redeemed*. The level of unused vouchers is referred to in the trade as "breakage". In December 2014 the UK Gift Card and Voucher Association estimated that the average breakage across the industry as a whole is around 6% (or £300 million).[3] Typically, consumers are more likely to fail to use smaller value vouchers.

7.6 These benefits, taken together, mean that the card and voucher market is a major source of revenue for retailers. It is therefore important that confidence in the sector is maintained.

THE VARIETY OF THE MARKET

7.7 The voucher market is large and varied. Gift cards and vouchers take different physical forms and are now increasingly digital. They come into consumers' possession in a variety of ways, and differ in how and where they may be redeemed.

Physical forms

7.8 Although paper vouchers were the most common type of voucher until 2008, they have now largely been replaced by plastic gift cards.[4] While gift cards represent the most common form of delivery, many providers are now turning to digital products. These could be in the form of codes delivered by email, QR codes to be presented on mobile devices, or smartphone apps with built-in NFR technology.

7.9 For most purposes, the physical form of the voucher is irrelevant. However, as we discuss below, the Electronic Money Regulations 2011 (EMR 2011) apply to plastic cards but not to paper vouchers. This adds another level of complexity to the law in this area.

How consumers acquire vouchers

7.10 Gift vouchers may come into a consumer's possession in a variety of ways. As their name suggests, vouchers may be purchased as a gift for special occasions such as birthdays or Christmas. These situations, where the purchaser buys the gift voucher directly from a retailer or reseller, are described in the trade as B2C (business-to-consumer) transactions.

7.11 However, not all vouchers are bought by consumers as gifts. The following are examples of other ways in which vouchers may come into consumers' possession:

(1) *From employers*, who offer vouchers to employees as incentives to reward performance or as part of a salary sacrifice.

[3] https://www.gov.uk/government/news/millions-wasted-as-people-dont-spend-gift-vouchers (December 2014).

[4] In 2014, plastic gift cards represented 72% of total sales, while paper vouchers only accounted for 28%. See UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf.

(2) *As part of a returns policy*, where retailers accept the return of unwanted purchases without the consumer having a statutory right to return them.[5]

(3) *As a promotional gift*, redeemable either with the retailer who issues it (for example, “spend £100 and receive a free £10 voucher”) or with another company (“open a bank account with us and receive a £50 store card”).

(4) *From home insurers*, who may provide a voucher to the value of the claim, rather than replacing a product directly.

7.12 B2B (business-to-business) transactions, such as purchases of vouchers by employers or insurers, now account for around half the market.[6] While B2C vouchers are usually sold at face value (a £10 voucher costs £10), B2B vouchers are typically sold to other businesses in bulk at a discount.

7.13 Only B2C transactions fall within our definition of consumer prepayment. However, retailers have told us that it is often impossible to distinguish between B2B and B2C vouchers. Both may look the same and be accounted for in the same way. Furthermore, in policy terms, some B2B vouchers may raise similar issues. For example, employees who receive vouchers as part of a reward scheme may lose the value of their rewards if the retailer becomes insolvent. We therefore do not propose to draw a distinction between B2B and B2C transactions in this paper.

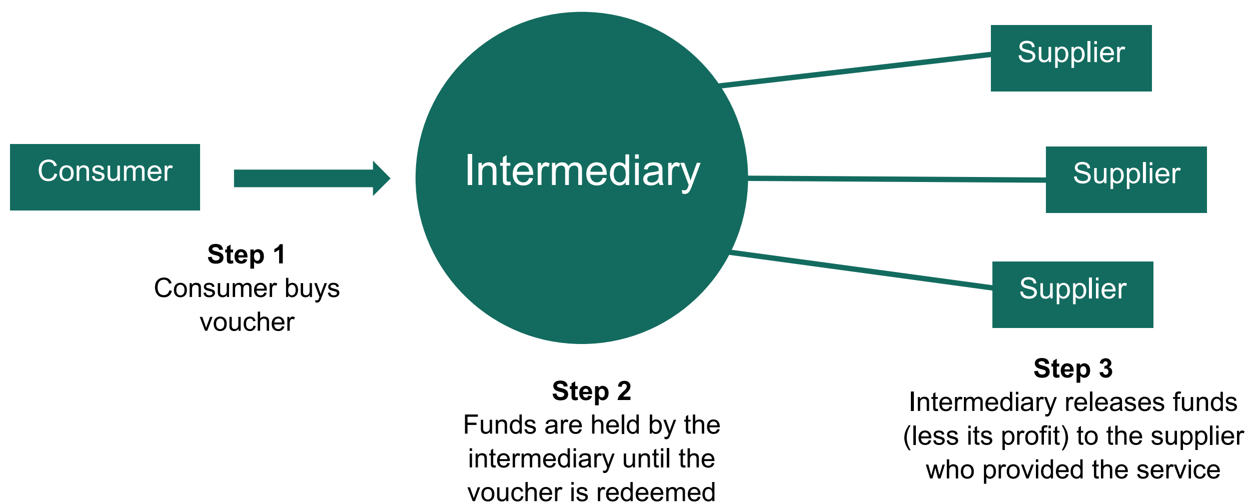
HOW VOUCHERS ARE REDEEMED

7.14 Vouchers also differ in the way they are redeemed. As we explain below, some may be redeemed at only one retailer; some at a limited pool of retailers; some at many retailers but for a limited category of product; while some offer a wider range of both products and outlets.

7.15 The differences between these business models affect the insolvency risk. For single retailer vouchers, consumers run the risk that the retailer will become insolvent. However, in the case of multi-retailer models, the funds are typically held by intermediaries, and here the main risk is that the intermediary will become insolvent. The following diagram shows how funds are held by intermediaries:

[5] Although many retailers offer it, there is no statutory 28 day “change your mind” period.

[6] See UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf.



7.16 The differences also influence the regulatory regime. As we explain below, electronic cards which may be redeemed for a wide range of products from many outlets are regulated as electronic money. However, other redemption models are not regulated.

Vouchers for a single retailer or group of retailers

7.17 In Chapter 3, we analysed a sample of insolvent retailers. The majority of these retailers had issued vouchers which became an issue in the insolvency. In nine out of 15 cases the vouchers were honoured in whole or in part, either by the administrator or by a subsequent purchaser. The best known example was HMV, whose vouchers which could only be redeemed in HMV stores. After substantial press criticism, the administrator took the commercial decision to honour the vouchers.

7.18 Retail groups may also issue gift vouchers which can be redeemed at any retailer in the group. An example – not drawn from our analysis – is the Arcadia group, which issues vouchers for its group members: Burton, Dorothy Perkins, Evans, Miss Selfridge, Topshop and Wallis. Vouchers bought in any of these stores may be redeemed at any of the others. When Woolworths entered administration, consumers held vouchers issued by the Kingfisher Group which had been redeemable at Comet, B&Q or Woolworths.[7]

7.19 Vouchers which can only be redeemed at one retailer or a group of retailers are often referred to as “closed loop” products. Closed loop vouchers are often bought through the retailer or a member of the retailer’s group. However, in recent years, “gift card malls” have become popular. These are stands in retail outlets (and online) where consumers may choose from dozens of gift cards for different retailers.

[7] See para 3.120.

7.20 Cards displayed on "gift card malls" are sold through distributors. Where, for example, a consumer buys a voucher for a toy store in a supermarket, the supermarket remits the payment (less a commission) to a distributor who then remits it (less a commission) to the toy store. However, in this model, there is relatively little risk to consumers from the distributor becoming insolvent. The intermediary holds the payment for a short time (typically three weeks) and we were told that the toy store would honour the gift voucher which bears its name, even if the distributor ceased trading.

7.21 Although the vendor of the gift card incurs no legal liability should the retailer cease to trade, some may offer a refund on a voluntary basis. For example, during the period in which HMV vouchers were not accepted by the administrators, Asda offered refunds to customers who had purchased an HMV gift card in their stores.[8]

Vouchers for a specific range of products

7.22 The first gift voucher to appear in the United Kingdom – the National Book Token – is an example of such a product. Book tokens may be redeemed at any participating bookshop for the purchase of one type of product. Other examples include the National Garden Gift Voucher issued by the Horticultural Trades Association (HTA), and Theatre Tokens issued by the Society of London Theatre.

7.23 Some of these products are issued by trade bodies which operate on a not-for-profit basis to promote the industry. Others may be organised by intermediaries on a commercial basis.

7.24 For these types of vouchers, the funds will be held by intermediaries. Unlike gift cards sold through gift card malls, the funds are not passed on to the supplier until the voucher is redeemed and the supplier submits the claim. The benefit of this model is that it protects consumers against the insolvency of individual retailers. Were one bookshop to cease trading, the book tokens would continue to have value and be redeemable in other participating retailers.

7.25 The corollary is that intermediaries may hold large amounts of consumer funds. If the intermediary itself becomes insolvent, their gift cards or vouchers would be worthless. Insolvency is unlikely where funds are held by not-for-profit organisations or by other reputable businesses, which do not undertake other risky forms of trading and which put funds aside in low-risk investments to await claims from suppliers. However, insolvency is more likely where less scrupulous intermediaries use the funds for other, riskier, purposes. There is nothing in the law to prevent them from doing this.

Vouchers for a specific product or service

7.26 All of the products mentioned above are "denomination vouchers": they either have a face value of a specific amount (for example, a voucher with a face value of £10 or £20) or may be loaded with a certain amount.

[8] See http://your.asda.com/news-and-blogs/bought-a-hmv-gift-card-at-asda-we-can-help.

7.27 Other vouchers offer the holder the right to redeem a particular product or service, which we will call "experience vouchers". Examples include a voucher for a flying lesson, for a hot air balloon ride or for a spa day. Sometimes the recipient is offered an experience as a gift, but then has the right to redeem the voucher for some alternative service provided by third party suppliers in the intermediary's network.

7.28 Typically, for these types of product, the funds will be held by intermediaries in the same way as vouchers for a specific range of products. The risks are similar. The main example of an insolvency for this model was Red Letter Days, which entered administration in 2005 with around 140,000 vouchers outstanding, having failed to retain funds to pay suppliers.[9] Loss to consumers was avoided when the new purchasers of the business agreed to honour outstanding vouchers.

Vouchers for a specific range of outlets

7.29 These vouchers are often available for use in a specific shopping centre. An example would be the Westfield Gift Card, which may be used at any retailer in any Westfield shopping centre in the United Kingdom.[10]

7.30 Unlike the other vouchers we have described, the card is issued by a financial institution, Wirecard Card Solutions Limited, which is authorised and regulated by the Financial Conduct Authority. It is part of the MasterCard scheme and operates in a similar way to debit and credit cards, described in Chapter 5. However, as we explain below, the card is not subject to the EMR 2011 as the "limited network exemption" applies. The funds on the card are therefore not segregated or subject to a priority in favour of the cardholder.

Multi-retailer/multi-purpose vouchers

7.31 Gift cards or vouchers which may be used at an unlimited range of retailers for a variety of purposes are described as "open loop" products. Examples in the United Kingdom include the Love2Shop gift card and the One4All gift card. Travel currency cards are another example, though not a gift product: consumers can load an amount onto the card in a foreign currency and use this money for purchases abroad.

7.32 Where these products are in the form of paper vouchers, they will not be subject to regulation under the EMR 2011 as they are not electronic. However, gift cards which may be redeemed at a large number of otherwise unconnected retailers will be subject to the EMR 2011.

ELECTRONIC MONEY

7.33 As we have seen, a wide variety of cards and vouchers is available. At one extreme, some are simple contractual promises from a single retailer to provide goods or services up to certain value. At the other extreme, these products begin to resemble money. They are prepaid tokens which can not only be passed from individual to individual, but can also be redeemed for goods and services from a wide range of retailers.

[9] Red Letter Days, *Statement of administrator's proposals* (September 2005) para 13.1.

[10] http://uk.westfield.com/uk/news/westfield-gift-card-faqs/.

7.34 Although issuing vouchers for contractual promises is not regulated, issuing money is a regulated activity, at least if it is done in electronic form. It is perhaps not surprising that the issuing of money is regulated. There are clear risks if businesses are entitled take payment of money in return for mere "tokens" in the form of electronic data, without safeguarding the funds in any way. The difficulty, however, is drawing the line between electronic money and a standard gift card. As we discuss below, this distinction is not entirely clear and has caused difficulties.

The Electronic Money Regulations 2011

7.35 The EMR 2011 implement the European Second Electronic Money Directive (2EMD). Regulation 2(1) of the EMR 2011 defines electronic money as follows:

> "electronic money" means electronically (including magnetically) stored monetary value as represented by a claim on the electronic money issuer which—
>
> (a) is issued on receipt of funds for the purpose of making payment transactions;
>
> (b) is accepted by a person other than the electronic money issuer; and
>
> (c) is not excluded by regulation 3 [the limited network exemption].

Safeguarding funds

7.36 If a card falls within the scope of regulation 2(1), the issuer must safeguard funds received in exchange for the electronic money issued.[11] 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.[12] The Treasury noted in 2010 that there was, at the time, no insurance option in the United Kingdom and segregation was expected to continue.[13]

7.37 The EMR 2011 also protect cardholders against the claims of other creditors of the electronic money issuer (which, in most cases, will not be a retailer). This is achieved by requiring claims of electronic money holders to be paid from the asset pool in priority to all other creditors (after deduction of the costs of distribution, but before the expenses of the insolvency proceeding).[14]

7.38 Electronic money products are not covered by the Financial Services Compensation Scheme. If holders are not able to recover all (or any) funds from the insolvent issuer of the electronic issuer, they will not be further compensated.

[11] EMR 2011, reg 20.

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

[13] HMT, 2EMD Stakeholders' Liaison Group (2010). We do not know whether this continues to be the case.

[14] EMR 2011, regs 24(1) and 24(2).

The limited network exemption

7.39 The main exemptions to the EMR 2011 are set out in regulation 3(a). This excludes money stored on instruments that can be used to acquire goods or services only:

(1) in or on the electronic money issuer's premises; or

(2) under a commercial agreement with the electronic money issuer, either within a limited network of service providers or for a limited range of goods or services.

7.40 The first limb, in regulation 3(a)(1), excludes gift cards which may only be used at the place where they are issued.[15]

7.41 The exclusion in regulation 3(a)(2), known as the "limited network exemption", is more problematic. Recital 5 of the 2EMD provides guidance on how the phrase should be interpreted. It states that the example applies to a card:

> if it can be used only either for the purchase of goods and services in a specific store or chain of stores, or for a limited range of goods or services, regardless of the geographical location of the point of sale.

Recital 5 then provides some examples of excluded instruments:

> Such instruments could include store cards, petrol cards, membership cards, public transport cards, meal vouchers or vouchers for services (such as vouchers for childcare...), which are sometimes subject to a specific tax or labour legal framework designed to promote the use of such instruments to meet the objectives laid down in social legislation.

Finally, recital 5 explains that the exemption should not apply to cards limited to a list of merchants if the intention is to expand the list in an unlimited way:

> Instruments which can be used for purchases in stores of listed merchants should not be exempted from the scope of this Directive as such instruments are typically designed for a network of service providers which is continuously growing.

7.42 The recital does not indicate whether a card limited to a few hundred stores in a single shopping centre should be included or excluded.

[15] See below at para 7.45 for examples.

7.43 Concern has been expressed that Member States have not interpreted the exemption in a coherent manner or have imposed additional conditions for exemption (such as a maximum amount which may be loaded onto the card).[16] This may result in the same electronic money products being subject to different levels of regulation in different Member States. The European Union is currently reviewing the Payment Services Directive, which has an analogous limited network exemption, and may soon undertake a review of the 2EMD. The limited network exemption is likely to be examined and, potentially, clarified.[17]

FCA guidance

7.44 In the United Kingdom, the FCA is responsible for deciding whether or not the limited network exemption applies. It has issued some guidance on the exemption in the EMR 2011, and also refers to the guidance on the similar exemption in the Payment Services Regulations 2009.[18]

7.45 Products which may only be used on the issuer's premises, and thus fall under the first limb of the exemption, include staff catering cards, tour operator cards for use within its holiday village, and store cards which can only be used at the store's premises.[19]

7.46 Products which fall under the second limb of the exemption because they may only be used within a limited network of service providers or for a limited range of goods or services including: [20]

(1) Transport cards such as the Oyster card used by various providers of public transport in London;

(2) Petrol cards where these are issued for use at a specified chain of petrol stations;

(3) Membership cards which can only be used to pay for goods or services offered by a specific club or organisation; and

(4) Store cards, where the card can only be used at a specified chain of stores at their premises or on their website.

[16] Joint Committee of the European Supervisory Authorities, *Report on the application of AML/CTF obligations to, and the AML/CTF supervision of e-money issuers, agents and distributors in Europe* (December 2012) JC 2012 086, pp 7 and 8, https://eiopa.europa.eu/Publications/Reports/JC_2012_086__E-Money_Report__-_December_2012.pdf.

[17] See, for example, the comments of the European Commission on article 3(k) of its proposal for a revised Payment Systems Directive, p 10, COM(2013) 547 final.

[18] Financial Conduct Authority, *The FCA's role under the Electronic Money Regulations 2011: Our approach* (June 2013) p 8, http://www.fca.org.uk/static/documents/emoney-approach.pdf.

[19] Financial Conduct Authority, Perimeter Guidance Manual (PERG) 15.5: Guidance on the scope of the Payment Services Regulation 2009, Q40, http://fshandbook.info/FS/html/handbook/PERG/15/5.

[20] See previous footnote.

7.47 In the case of a prepaid card for use in a particular shopping centre, the product will be considered electronic money unless:[21]

(1) it is made clear in the relevant terms and conditions of the card that the purchaser of the value is only permitted to use the card to buy from merchants located within that particular shopping mall; and

(2) the facility to use the card to purchase goods and services outside this shopping mall has been disabled.

7.48 It is clear from this guidance that relatively few gift cards are regulated in this way as most fall within the limited network exemption. Most of the market is unregulated. Intermediaries who issue "closed loop" vouchers which are unregulated may therefore use the payments they receive as working capital for their businesses, without ring-fencing or protecting the funds. On insolvency, the voucher holders will be unsecured creditors (whose claims rank below those of floating charge holders).

TERMS AND CONDITIONS

7.49 Consumers who purchase gift vouchers do so subject to a number of terms and conditions, most of which display a high degree of similarity.

Registration requirement

7.50 Gift cards and products in the United Kingdom do not tend to require either the issuer or the holder to register the voucher. Administrators have told us that this can make it difficult to know how many vouchers are in circulation and means that they have no way of contacting purchasers and/or holders of these products.

Expiry dates

7.51 Arguments exist for and against the inclusion of expiry dates on gift vouchers.

7.52 On the one hand, expiry dates limit the time period during which a consumer may redeem the gift card. Some consumers think this is unfair because they have exchanged money, which does not have any such limitation, for (in the case of denomination vouchers) a money-like product, which does. This means that at the end of the expiry period, the retailer effectively gets "free money". While this is also the result where the holder does not redeem the voucher ("breakage"), the difference in that case is that the consumer could have used it if he or she had wanted to, whereas if the voucher has expired, he or she is prevented from using it.

[21] Financial Conduct Authority, PERG 3A.5: Guidance on the scope of the Electronic Money Regulations 2011, http://fshandbook.info/FS/html/handbook/PERG/3A/5.

7.53 On the other hand, the mismatch between the time at which the retailer receives the revenue (on purchase of the gift card) and the unknown point in the future where it will have to provide goods or services can make it difficult for the retailer to assess accurately its current and future liabilities.[22] Having an expiry date acts as a cut-off point, after which the liability ceases to exist or never materialises, depending on the accounting model adopted. The ability to assess outstanding liability and the likelihood of its materialising is particularly important when administrators assess whether it is commercially viable to continue honouring gift vouchers.

7.54 Expiry dates are common in the United Kingdom. Gift vouchers are typically valid for between six months and two years, though the date from which this period starts to run will depend on the terms and conditions of the gift card.[23] Issuers of regulated electronic money products are required to retain and continue to safeguard funds for a period of six years after the termination of the contract (which would include, for example, the expiry date of a gift card).[24]

7.55 We appreciate consumers' desire for unlimited expiry dates when retailers are solvent, but we can see arguments to limit claims on insolvency to vouchers issued in the previous two years. This would make it easier for retailers to provide voluntary protection for such cards, as it would be easier either to present the total liability risk to insurers, or hold funds on trust for a specified period of time. Administrators may also be more likely to honour vouchers if they know the overall limit on the number of vouchers which may be presented. One reason why administrators hesitate to agree to honour vouchers is the fear that an unknown number of very old vouchers will be retrieved from the bottoms of drawers.

THE EFFECT OF INSOLVENCY

7.56 Our analysis in Chapter 3 shows that consumer losses on insolvency are usually moderate. Out of 15 high street insolvencies, gift vouchers were honoured in full or in part in nine cases. These firms traded in administration and in most cases administrators were able to take commercial decisions to honour vouchers, in order to preserve the value of the brand and to bring consumers into the stores. In some cases it was the incoming purchaser of the business which decided to honour the vouchers.[25]

[22] We are not aware of standard accounting models for gift voucher income and liability in the United Kingdom. Many retailers appear to defer the majority of income from gift vouchers, whilst taking account of historical redemption rates and patterns.

[23] The time limit for some gift cards starts running from the date of purchase. However, in the case of most single-retailer vouchers in the United Kingdom, the terms and conditions will impose a 24 month expiry period from last use of the gift card.

[24] EMR 2011, ss 46 and 43. The contract between the electronic money issuer and electronic money holder terminates "when the right to use electronic money for the purpose of making payment transactions ceases" (s 43). The consumer's right of redemption is therefore limited to a period of six years following the expiry of the gift card.

[25] In the case of Game, the administrators honoured gift vouchers once a purchaser had been secured, and the purchaser also did so. In Dreams, the purchaser honoured vouchers.

7.57 In six cases, vouchers were not honoured. Here, consumers ranked as mere unsecured creditors in the retailer's insolvency. The overall effect of these losses, however, was moderate rather than severe. In some cases the retailers had sold only a limited value of vouchers. For example, in Jessops, the value of vouchers in circulation was only £870,000. In other cases the losses 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 value of each voucher was only £8.12.

7.58 However, the analysis in Chapter 3 focused on vouchers where the retailer issued the voucher, held the funds and was liable to provide goods and services itself. Different considerations apply to vouchers where the funds are held by intermediaries but the goods and services are provided by third party suppliers. Risks arise where an intermediary holds significant funds for an extended period and uses those funds for unconnected purposes, in another part of its business. In these circumstances, the intermediary would be unlikely to trade in administration and may not have a brand which is worth preserving. As we saw, vouchers which fall within the limited exemption of the EMR 2011 are unregulated. Although most are highly reputable businesses, which do not use voucher funds for other purposes, they could be undermined by those which do.

7.59 So far there has been little lasting reputational damage to the industry. The gift voucher market in the United Kingdom appears buoyant: between 2011 and the end of 2014, the market increased from £4.6 billion to £5.4 billion.[26]

7.60 On the other hand, the gift voucher industry only survives because consumers have confidence in it. At present, consumer confidence in gift vouchers is not based on a careful assessment of the insolvency risk and the regulatory protection.[27] Rather, consumers have confidence because they have not considered the insolvency risk at all. The case histories provided by Citizens Advice suggest that when consumers find that their vouchers have become worthless they tend to use terms like "fraud", "robbery" and "theft". They provided the following examples:

> 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 defrauded of my money.
>
> 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?

[26] See UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf.

[27] Consumers' understanding of the effect of the Electronic Money Regulations appears to be negligible to non-existent. In an opinion poll commissioned by One4All in May 2013, 91% of respondents admitted to being unaware of regulated gift cards: http://www.one4allgiftcard.co.uk/blog/?p=731.

7.61 This makes the reputation of the industry vulnerable to one or two major insolvencies where vouchers are not honoured. If this occurs, the repercussions may be felt throughout the market. However, we are aware that the safeguarding requirements set out in the EMR 2011 are not likely to be sufficiently practical or affordable for the majority of businesses.

7.62 In Chapter 10, we consider the options available to retailers who want or need to protect consumer prepayments, and consider whether the options are sufficiently practical and affordable. In light of the low level of financial loss voucher holders may suffer on retailer insolvency, we suggest in Chapter 11 that voucher issuers should be encouraged to implement protection on a voluntary basis. However, we also discuss whether there is a need to regulate high-risk sectors which currently fall outside the Electronic Money Regulations 2011 such as savings schemes and certain intermediary models.

CHAPTER 8
ASSESSMENT

8.1 In this chapter, we assess the scale and nature of the problem and ask if there is a need for reform. We introduce five options for change, discussed in more detail in the following chapters.

THE SCALE OF THE PROBLEM

The problems of research

8.2 We are not able to provide an authoritative figure on the total losses caused to prepaying consumers each year by retailer insolvency. Two previous reports have attempted to survey consumers to ask about losses: the Office of Fair Trading (OFT) in 1984 and Consumer Focus in 2009. Based on its survey, Consumer Focus estimated that consumers had lost around £133.3 million of prepayments in the last two years, but only some of these losses were caused by retailer insolvency.

8.3 Such studies suffer from two problems. First, insolvency losses are relatively uncommon, which means that figures have to be extrapolated from small sample sizes.[1] Secondly, consumers find the process of dealing with retailer insolvency particularly confusing, which makes it difficult for them to quantify their loss. They may initially believe that they have lost their deposits, only to find that a new purchaser will eventually honour the contract. Alternatively, they may think that they will receive a refund, only to discover that they are paid a fraction of their claim. The final position may not become clear for years.

8.4 Nor is it possible to estimate total losses from administrators' reports. These vary widely in the level of information they provide, and again may not present the final position.

A small but intractable issue

8.5 It is safe to say that the level of consumer detriment is low compared to more common problems, such as faulty goods or misleading statements, where consumer detriment has been estimated at over £3 billion.[2] Despite the press headlines, retailer insolvency is still relatively rare and (as discussed in Chapter 3) even where it occurs there are several ways in which consumers may be recompensed.

[1] Although the Consumer Focus sample of 16,000 consumers included 542 people who had a problem with prepayments, only around 100 of these problems were caused by insolvency, and in only some of these cases consumers lost all of the payment.

[2] See, for example, Consumer Focus, *Consumer Detriment 2012*, http://www.consumerfocus.org.uk/publications/consumer-detriment-2012 and Consumer Focus, *Waiting to be Heard: Giving consumers the right of redress over Unfair Commercial Practices* (2008), http://www.consumerfocus.org.uk/publications/waiting-to-be-heard.

8.6 The problem is not that consumer losses are common, but that when they occur they are particularly stark. The comments reported to us by Citizens Advice reveal that consumers struggle to understand insolvency law. They are often astonished to find that money paid in good faith has simply been lost. As these extracts show, consumers question whether this outcome is allowed by the 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?
>
> 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 [trader] now claims that it is a totally different company and will not honour any outstanding orders. However, they use the same name, the same website and the same Facebook page. They have even kept my online account with my contact details and sent me advertising emails & texts. Only my outstanding orders have disappeared from my online account. I don't understand how this is legal?
>
> Went into the store a week ago to find that exactly the same goods we had paid for were on open sale! I asked if I could take the goods that were on sale in lieu of the ones we had ordered and paid for. I was told that I couldn't because the bar code on my order was not the same as the bar code on the doors that were for sale!!! I think this is nothing but a pathetic excuse and wonder whether what they are doing is legal.

8.7 Of course, in all these cases, the insolvency practitioner's stance was lawful. When a company is in administration, the law may require administrators to refuse to deliver orders. While solvent companies may often respond to consumer concerns by doing more than the law demands, administrators are strictly constrained: they cannot prefer consumer claims over the claims of other creditors.

8.8 This discrepancy between consumer expectations and the law can lead to negative press coverage, swollen postbags to Members of Parliament and even (in the case of World of Leather) public disorder. It was put to us that consumers should be educated to be more aware of insolvency law and its associated risks. However, this would potentially undermine rather than increase consumer confidence, particularly in gift vouchers and in the furniture sector.

A NEED TO RECONSIDER CONSUMER PROTECTION ON RETAILER INSOLVENCY?

8.9 When companies become insolvent, it is inevitable that losses will fall on creditors. We do not think that consumers can or should be sheltered from all loss. As the Cork Committee pointed out, consumers often lose small amounts. Individual contractors may suffer much greater hardship. For example, when City Link entered administration in December 2014, many of its van drivers were classified as contractors rather than employees and were not afforded any protection.

8.10 On the other hand, we have identified four reasons for examining the protections offered to consumers:

(1) The discrepancy between consumer expectations and the law suggests that the subject should at least be considered.

(2) The retail economy depends on consumer confidence. That confidence could be dented by even a handful of retailer insolvencies. The gift voucher market, in particular, could be damaged by the insolvency of a single large retailer insolvency, if that insolvency rendered a significant volume of vouchers worthless.

(3) Consumer prepayments bring new money into the business. They 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) Businesses with financial problems (who find it difficult to borrow money from sophisticated lenders) may seek to increase prepayments from consumers in the knowledge that the goods or services may never be delivered. Under the current rules, floating charge holders benefit directly from these prepayments. This may provide an incentive for businesses and their floating charge holders to require increased prepayments inappropriately in the weeks and months prior to insolvency.

8.11 We ask consultees whether, in these circumstances, they agree that the protection available to consumers on retailer insolvency should be reformed.

PROBLEM SECTORS

8.12 We think that risk to consumers arises from a combination of two main factors:

(1) The value of the prepayment; and

(2) The period of time between prepayment and delivery of the goods or services.

8.13 As we noted in Chapter 1, consumers prepay for many goods and services including flights, concert tickets, wedding receptions, football season tickets, glazing and building work. However our analysis of retailer insolvencies in Chapter 3 identified two areas as being of particular public concern: gift vouchers, where the value of the prepayment may be low but the period of between purchase and redemption significant; and deposits in the furniture and home improvement sectors, where both a substantial prepayment may be made and where delivery of the goods is subject to a lead-time of several weeks or months.

Gift vouchers

8.14 Most high street retailers sell gift vouchers. 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 vouchers in both the Zavvi and Borders administrations and, since vouchers will very often be given as gifts, both the buyer and the recipient stand to be disappointed (in different ways) if the vouchers are not honoured. The issue often attracts press interest.

8.15 As we discuss in Chapter 7, some gift vouchers can be thought of as simple contractual promises from a single retailer to provide goods or services up to a certain value. Others begin to resemble money in that they are electronic money products which can not only be passed from individual to individual but can also be redeemed for goods and services from a wide range of retailers. Although issuing money is a regulated activity, most gift cards and electronic money products are not regulated due to the “limited network” exemption in the Electronic Money Regulations 2011: for example, those which can only be used for a single retailer as well as those which can be used in a specific shopping centre or for a particular product are exempt.

8.16 In fact, consumer losses have not been as prevalent as might appear. If it is in the interests of creditors as a whole, administrators may make a commercial decision to honour the vouchers during a period of administration - because it will either preserve the value of the brand or help sell surplus stock. Alternatively, a subsequent purchaser of the brand may decide to honour vouchers to bring people into the store or foster goodwill.

8.17 In the 15 cases we looked at, in seven cases gift vouchers were honoured to 100% of their value during a period of trading in administration. In a further two cases, gift vouchers were treated as partially redeemable. 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 themselves decided not to honour the vouchers (Republic, JBB Sports, La Senza and Peacocks). As far as we have been able to estimate, the total losses to consumers amounted to over £7 million. In other words, more than £7 million of vouchers in circulation were rendered worthless (though some may not have been redeemed in any event).[3]

8.18 However, in all of these cases, the retailer which issued gift vouchers was also the one which held the consumer funds and accepted the vouchers. The company also held the stock, which made it easier for the administrator to trade in administration and to continue to accept vouchers during that period, thereby greatly reducing potential consumer detriment. This does not happen in every case, as some types of gift vouchers are more difficult for an administrator to honour. This is particularly the case where the retailer which issued the voucher and held the funds is not the one which provides the goods or services – such as where vouchers are issued by an intermediary which becomes insolvent.

8.19 Interest in this issue tends to be reactive; for example, as well as negative press coverage, the HMV administration led to an MP proposing a private members' bill on gift vouchers and insolvency. This proposed to make purchasers of gift vouchers preferential creditors during the administration of a company.[4]

Deposits held by retailers in the furniture and home improvement sectors

8.20 Many of the largest losses concern deposits for furniture, bathrooms and fitted kitchens. Information about the level of consumer repayments was available in six cases. The total of prepayments held in these six cases was around £60 million.

[3] For example, it was estimated that Comet had gift vouchers totalling £4.7 million in circulation when administrators were appointed, but only £1.2 million was redeemed during the period of trading in administration.

[4] The Bill failed to complete its passage through Parliament before the end of the 2012-13 parliamentary session and therefore fell.

Table 5: Value of consumer deposits held by retailers

Year	Retailer	Value of consumer deposits held
2008	MFI	£27.3 million
2009	Land of Leather	£3.5 million
2011	Homeform	£5.6 million
2011	Focus DIY	£3 million
2013	Dreams	£11.8 million
2013	Dwell	£6 million
2014	Paul Simon	£2.4 million

8.21 Not all 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 was taken). Others were fulfilled by new buyers of the business. Consumers who had paid for items worth over £100 and less than £30,000 on a credit card had legal rights against their bank. Others who had paid by debit card requested a refund from the bank which issued the card, and recovered their payment through chargeback arrangements.

8.22 The heaviest losses fell on consumers who had paid by cash or cheque and who tend to be drawn from less well off socio-economic groups.[5] Although only some figures are available, these "cash buyers" lost around £8.5 million in the MFI insolvency; £2.6 million in Homeform; and £1.1 million in Land of Leather. An analysis of case histories provided by Citizens Advice suggested that the average amount lost in the cases reported to them was £698.

Other sectors

8.23 We ask consultees whether there are other sectors in which consumer prepayments are problematic in the event of retailer insolvency.

OPTIONS FOR CHANGE

8.24 In Chapter 1, we identified themes from previous reports: the importance of "chargeback" arrangements relating to credit and debit cards; voluntary sector-specific protections, and whether these protections should be backed by regulation; and a change to insolvency law. We return to these themes in the next five chapters.

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

Making chargeback more transparent

8.25 In Chapter 5, we explored the importance of chargeback arrangements, by which consumers who pay by credit and debit card may seek recourse against their card issuer if the goods or services are not delivered. Consumers often lack information about chargeback. They may not know how to request a chargeback, or how to pursue the request if they meet an initial rebuff.

8.26 In Chapter 9, we make proposals to increase the information available to consumers about chargeback. We also consider whether voluntary chargeback arrangements should be put on a statutory footing.

Making voluntary protection easier for traders

8.27 In Chapter 6, we described the many attempts to encourage the voluntary protection of prepayments through industry codes. In particular, prepayment protection is required under the Consumer Codes Approval Scheme, administered by the Chartered Trading Standards Institute (CTSI). In 2011, CTSI's predecessor, the OFT, commented that prepayment protection was "a key issue of consumer confidence, although some sponsors find it the most difficult requirement to meet".[6]

8.28 In Chapter 10, we look at the difficulties involved in protecting consumer prepayments through trusts, bonding and insurance. We ask if anything can be done to make it easier for traders to protect prepayments on a voluntary basis. In particular, we consider the merits of a "consumer charge" which traders could use voluntarily to give secured status to some specified consumer claims.

A need for more sector-specific regulation?

8.29 There has been a long-standing debate over whether protection of consumer prepayments should be left to voluntary arrangements, or whether those arrangements should be underpinned by regulation. Regulations have been introduced in some sectors, most notably the package travel industry.

8.30 In Chapter 11, we summarise the arguments which have been made for and against sector-specific regulation. We identify two high-risk areas in the voucher market: savings schemes; and limited network voucher intermediaries which hold significant funds over a long period and which use those funds for other purposes. We provisionally propose that legislation should provide the Government with reserve powers to introduce regulations in these areas if it were to prove necessary.

Preferential status for a limited category of consumer claims

8.31 As we have seen, under current insolvency law, consumers are treated as unsecured creditors. Previous reports have suggested that this should be changed, to treat consumers as preferred creditors, ranking above floating charge holders.

[6] Office of Fair Trading response to Department for Business, Innovation & Skills, *Consumer Landscape Review* (May 2011) para 9.16.

8.32 We do not think that all consumer claims should be given preferential status. Many claims are small, which means that they are expensive to distribute and failure to satisfy them will often not cause much hardship (although it may have a disproportionate impact on the lowest-income consumers). Small prepayments are usually for gift vouchers rather than deposits so are less likely to be put towards larger, more necessary expenditure such as white goods or bathroom suites. Some types of debt, such as damages for faulty goods, are also particularly difficult to assess. To provide a special status for all consumer debts could substantially reduce payments to secured lenders, thereby making lending less available and more expensive.

8.33 However, in Chapter 12 we set out proposals for giving preferential status to a small and limited category of consumer claims. This is where businesses take significant sums of new money from consumers shortly before entering insolvency and no other protections are in place.

When should consumers be considered to own goods?

8.34 Who owns goods is a live issue on retailer insolvency. If ownership has passed to the consumer, the goods do not form part of the general asset pool: instead they must be made available for the consumer to collect.

8.35 We described the law on this issue in Chapter 2. Section 18 of the Sale of Goods Act 1979 sets out various default rules for when ownership passes. For unascertained or future goods, ownership passes to the buyer when the goods are "unconditionally appropriated" to the contract. This rule was developed for commercial contracts and is somewhat obscure. The case law suggests that it can operate harshly against consumers. A consumer does not necessarily own goods which have been paid for and set aside. Instead it is said that the goods must be irrevocably committed to the contract.[7]

8.36 In Chapter 13, we propose a new default rule to apply to consumer contracts. This would state that ownership transfers to the consumer when goods have been identified for the fulfilment of that contract. This would mean that a consumer would own goods which have been labelled, altered or set aside for them.

THE NEED FOR PUBLIC DEBATE

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

8.38 The aim of this consultation paper is to provoke a debate about these issues. Any proposals we make are purely provisional, and often we simply ask questions. We hope that consultees will respond to this consultation. Details on how to do so are set out at the beginning of this paper.

[7] *Carlos Federspiel & Co v Charles Twigg & Co* [1957] 1 Lloyd's Rep 240.

QUESTIONS

Q1 Do consultees agree that the protection given to some types of consumer prepayments on retailer insolvency should be reformed?

Q2 In this report we identify two particular sectors where consumers risk losses on retailer insolvency: gift vouchers and deposits in the furniture and home improvement sectors. Are there other sectors in which consumer prepayments are particularly problematic in the event of retailer insolvency?

CHAPTER 9
PROPOSALS AND QUESTIONS: CHARGEBACK

THE IMPORTANCE OF CHARGEBACK

9.1 In Chapter 5, we explained how consumers who pay by credit and debit card may seek recourse against their card issuer if the goods or services are not delivered. Our analysis shows how important this is on retailer insolvency, though it has implications for many other consumer problems.

9.2 A consumer who makes a purchase with a credit card is protected under section 75 of the Consumer Credit Act 1974, provided that the price of the item is more than £100 and not more than £30,000. For those buying on a debit card, or for those making smaller purchases on a credit card, the protection has been described to us as "voluntary". Card issuers may decide to reverse the transaction and recover the money from the merchant acquirer, using the chargeback procedures set out in the Visa and MasterCard scheme rules.[1]

9.3 The non-statutory chargeback arrangements have now become part of the consumer landscape. Although they do not benefit consumers who pay by cash or cheque, they play an important role in the overall package of protections for consumer prepayments. We would go so far as to say that, without them, much of the retail market place would cease to function in the way that it does. Consumers could no longer have confidence when buying online or purchasing goods or services they do not immediately receive. Nor would they buy from small online retailers.

9.4 We have noted that, compared with other EU countries, more consumers buy online in the United Kingdom, spending larger sums with a greater variety of retailers.[2] MasterCard told us that consumers in the United Kingdom also make proportionately higher use of the chargeback scheme compared to those in other EU countries. These two facts are linked.

9.5 As chargeback arrangements have become institutionalised, they are now less voluntary than might appear. Consumers who have been refused a chargeback have the right to complain to the Financial Ombudsman Service (FOS). Where a card issuer could have raised a chargeback through the scheme rules, the FOS may require them to compensate the consumer. However, if no chargeback is available, the FOS will not intervene.

1 We have been told that card issuers may also voluntarily undertake to bear the loss suffered by the consumers in some circumstances, without raising a chargeback under the card scheme rules.

2 Ecommerce Europe, *European B2C E-Commerce Report 2014*, "light" version available to download at https://www.ecommerce-europe.eu/website/facts-figures/light-version/download.

9.6 In practice, the chargeback rules in the Visa and MasterCard schemes often determine who does and does not get repaid when a retailer becomes insolvent. Where the consumer does not receive the goods or services they paid for, card issuers will usually refund the consumer (following FOS guidance and good practice). Where the sum justifies the cost, the card issuer will then recover the loss from the merchant acquirer. In turn, merchant acquirers act as proxies for consumers, assessing retailers' insolvency risk over time and holding back funds as collateral where they consider the risk to be real.

9.7 This system may result in considerable sums being refunded to consumers: following the MFI insolvency, for example, £19.3 million was refunded through chargeback.[3] 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.[4]

THE NEED FOR TRANSPARENCY

9.8 The main problem with chargeback is the lack of information about how it works. Consumers may not know how to request a chargeback, or how to pursue the request if they meet an initial rebuff. We have been told that card issuers take different approaches to how they train their staff to respond to chargeback claims, with some card issuers doing much more than others. If customers feel "fobbed off" they may not have accessible information about what to do next. This raises issues of fairness: well-informed consumers tend to get their money back, while those with less understanding of the financial system do not.

9.9 Visa and MasterCard argued that consumers did not need to know about the scheme rules, because the rules did not concern them. Instead, they said these were internal arrangements between card issuers and merchant acquirers. We think that this fails to appreciate the importance of the rules to consumers, who need to know when and how they can expect to obtain a refund from their card issuer. Chargeback arrangements now underpin the consumer market in the United Kingdom and are a matter of public concern.

PROPOSALS ON CHARGEBACK

9.10 Our view is that chargeback arrangements should be transparent. Below we make three proposals to improve information about how the chargeback system works, before considering whether chargeback should remain a voluntary means of protection.

[3] 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.

[4] See para D.67 of Appendix D and paras E.7 to E.8 of Appendix E.

Information from insolvency practitioners

9.11 Some insolvency practitioners (that is, administrators and liquidators) felt constrained about telling consumers to contact their card issuer to raise a chargeback. They were concerned that this might be seen to prefer one set of creditors (consumers paying by debit or credit card) against other creditors. The logic is that, unlike the credit card issuer's liability under section 75, every chargeback claim made has the effect of reducing the money released by the merchant acquirer for the benefit of creditors as a whole. However, other insolvency practitioners felt that this was not an issue and were happy to provide information.

9.12 We think that insolvency practitioners should give information to consumer creditors about the possibility of asking their card issuer to raise a chargeback. Our preliminary view is that the issue could be dealt with through guidance, rather than requiring legislative change. We hope that the Joint Insolvency Committee[5] will draft a Statement of Insolvency Practice (SIP) to encourage insolvency practitioners to provide consumer creditors with practical details about how to contact their card issuer to raise a chargeback.

9.13 We also think it would be helpful for insolvency practitioner to place a document on the retailer's website, which consumers could download and present to their bank, confirming that the company is in administration or liquidation and that goods or services are unlikely to be delivered.

Information from card issuers

9.14 We think that all card issuers should give consumers a brief explanation of how to raise a chargeback.[6] This should include:

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

(2) Details of situations in which consumers may ask their card issuer to raise a chargeback, including when a retailer enters administration, and what documentation needs to be provided to the card issuer;

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

5 The Joint Insolvency Committee (JIC) is made up of representatives from relevant professional bodies (including, for example, the Association of Chartered Certified Accountants and the Solicitors Regulatory Authority) and from the Insolvency Service. It has responsibility for the revision of Statements of Insolvency Practice. See https://www.icas.com/technical-resources/joint-insolvency-committee.

6 Some card issuers already do this. See, for example, http://ask.barclays.co.uk/help/day2day_banking/unrecognised_transaction.

9.15 We would welcome views on whether this can be dealt on a voluntary basis (perhaps with support from the Banking Standards Review Council) or whether it would require action from the Financial Conduct Authority. Bodies such as the Money Advice Service, a statutory body with responsibility for improving people's money management,[7] might also assist with the provision of information.

Information from card schemes

9.16 We think that the card schemes, Visa and MasterCard, should provide a publicly available authoritative guide on how chargeback works. This would benefit both consumers and retailers (some of whom, especially smaller ones, have also expressed confusion at the system). We think that this should be available online free of charge on Visa and MasterCard's websites, and should be kept updated as rules change.

9.17 Again, we do not think that this proposal would require legislative change and could be taken forward by the Payment Systems Regulator,[8] which started work on 1 April 2015.

The voluntary nature of chargeback

9.18 The crucial importance of chargeback on retailer insolvency leads to a more fundamental question. Should chargeback remain a purely voluntary arrangement in cases which fall outside the ambit of section 75 of the Consumer Credit Act 1974? The alternative would be to impose some new form of legal duty on banks to refund consumer prepayments made by credit and debit card whenever goods and services are not delivered.

9.19 In 2009, Consumer Focus recommended reform along these lines. It urged the Government to "consider upward harmonisation of payment card redress" to provide the same statutory protection for debit cards as is currently available for credit cards.[9]

9.20 As we discuss in Chapter 5, in Denmark consumers have a legal right to obtain a refund for payment in distance sales in some situations. The relevant provision is § 74 of the Danish Payment Service and Electronic Money Act 2011, and is set out in Appendix B. It applies in three situations, including non-delivery. It states that the consumer must first contact the retailer. If this is unsuccessful, the consumer may raise an objection with the card issuer. The card issuer must then credit the payer's account, and may only debit it again if the retailer can show that the objection is unjustified.

[7] The Money Advice Service was initially known as the Consumer Financial Education Body, the name used in the Financial Services Act 2010 which sets out its statutory objectives. See https://www.moneyadviceservice.org.uk/en/corporate/background.

[8] The Payment Systems Regulator is the new economic regulator for the payment systems industry in the United Kingdom. See https://www.psr.org.uk/.

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

9.21 The main argument against any legislative change in England and Wales (and the rest of the United Kingdom) is that the current system works well, and will not necessarily be improved by Government intervention ("if it ain't broke, don't fix it"). 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.

9.22 On the other hand, the voluntary nature of chargeback means that the card schemes could reduce it or even remove it. They told us that they had no plans to do so, but accepted that the possibility would be open to them. Given how important chargeback is, any moves to significantly reduce or remove the scheme could have a major detrimental effect on the entire retail sector. If this were to occur, we think that the Government would need to intervene.

9.23 Our current provisional view is that, provided chargeback is made more transparent, the case for legislative intervention has not been made out. However, the issue would need to be reconsidered if the card schemes were to make major changes to their current arrangements or indicated that they intended to withdraw them. The issue has implications which are much wider than just retailer insolvency, and we welcome respondents' views.

PROPOSALS AND QUESTIONS

Proposal 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.

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

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

(2) 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;

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

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

Q3 Do you agree with these proposals?

Q4 If so, do you have any comments on how they should be implemented?

Q5 Our provisional view is that chargeback should not be required by legislation. We seek views for and against legislating for new legal duties to be imposed on card issuers to refund payments in circumstances currently covered by chargeback.

CHAPTER 10
PROPOSALS AND QUESTIONS: POSSIBLE MEANS OF PROTECTION

10.1 In Chapter 2, we explained that consumers who make prepayments will be unsecured creditors if the retailer becomes insolvent before they receive the goods or services they purchased, unless the retailer has some additional protection in place for consumers.

10.2 Three main methods are open to retailers who wish to provide consumers with additional protection to apply in the event of the retailer's insolvency, but none are without difficulties:

(1) **Trust arrangements**. It is always open to businesses to put money into a segregated account and declare that this is subject to a trust in favour of consumers. However, trusts can be administratively complex, and involve legal and accountancy costs. They also deprive the business of working capital.

(2) **Bonding**. A bond may not provide sufficient protection if the value of the guarantee it provides is lower than the value of prepayments taken. In the travel industry where bonding is common, such arrangements are generally supplemented by an insurance-backed reserve fund.

(3) **Insurance**. This is an attractive solution but we have been told that the market is underdeveloped. Without a mass market for this form of insurance, costs will tend to be high.

10.3 In this chapter, we explore whether anything should be done to make it easier for businesses to introduce protections for consumers through these mechanisms. We also consider the possibility of a "consumer charge" as a completely new means of protection. We recognise that any protections, whether mandatory or voluntary, would have to be practical and affordable.

10.4 In the next chapter, we consider whether these kinds of protection should be voluntary or whether there is a case for introducing regulation, particularly in high-risk sectors. We also recognise that, in some sectors, taking steps to minimise the chance of insolvency occurring is actually more feasible than encouraging the introduction of protections for consumers which would only operate once the business became insolvent.

MORE FLEXIBLE TRUST ARRANGEMENTS?

10.5 We examined situations where directors establish a trust for consumer prepayments during the run-up to insolvency in Chapter 2.[1] Holding deposits on trust in the normal course of business can be fraught with difficulties. The initial legal costs may be high; independent trustees may need to be employed; and businesses may face accounting challenges. But for some types of business it is possible: for example, the Co-operative Food's "saving stamp" scheme is backed by a trust in which consumers' money is protected.[2]

10.6 The main objection presented to us was that holding all prepayments on trust would deprive businesses of their working capital as they would have no way to access the funds until the goods or services were provided.

Holding a proportion of funds on trust?

10.7 Where a retailer issues gift vouchers but also sells other goods, or has lending arrangements in place, they are less likely to require access to the funds received from the issuing of gift vouchers. Having to hold all funds on trust is mainly a problem for voucher intermediaries, which do not have any other income stream, and retailers which depend on prepayments to place consumers' orders (as in the furniture industry). In these cases, it may be more feasible for retailers to place only a proportion of consumer funds on trust, or to have some way of accessing some of the funds if necessary. The Park Christmas Savings Club, a member of the Christmas Prepayment Association, has arrangements in its trust deeds to allow the business to "draw-down" working capital subject to certain protections and limits.[3]

10.8 Although holding only some funds on trust would not allow consumers to recover the full amount of their prepayment on retailer insolvency, it would provide greater protection than currently exists ("something is better than nothing") and would be more workable for businesses.

10.9 Additionally, it may even enable the administrator to fund the provision of the goods or services for which the consumer contracted. One gift voucher intermediary we talked to provides vouchers that can be redeemed at a wide range of suppliers, which then bill the intermediary. We were told that approximately £60 of every £100 received is used to pay the suppliers and the remaining £40 is used for the intermediary's own overheads (including advertising and marketing) and profit. If that £60 were held on trust and the intermediary became insolvent, there may be sufficient funds in trust for the administrator to pay third party suppliers and fulfil the customer orders.

[1] Para 2.78 to 2.80.

[2] Subject to the costs of administering the trust being drawn from it in certain circumstances. See *The Co-operative Group Food Limited Christmas Stamp Savings Trust,* clauses 13.2 and 13.4. We are grateful to the Co-operative Group for providing us with a copy of the trust deed.

[3] See clause 8 of Park's declaration of trust, available at http://www.getpark.co.uk/CORPORATE/declaration.pdf.

10.10 We have considered how maintaining a proportion of prepayments on trust could be used in the furniture sector to overcome the problems of lost deposits. We illustrate the issues with some hypothetical figures, based on furniture costing £1,000 plus VAT. Assume a breakdown of costs as follows:

Paid to supplier on order	£300
Paid to supplier on delivery	£300
VAT liability	£200
Shipping/transport	£50
Retailer's margin	£350
Total	**£1200**

10.11 Excluding the retailer's profit, the cost of the item is £850 including VAT. If the consumer pays upfront in full when ordering, and the retailer immediately places the order with the supplier (paying the first £300 to the supplier), it could be argued that it would be sufficient to keep only £550 in trust. If the retailer entered administration, this would be sufficient for the administrator to pay the supplier, VAT and shipping costs, and deliver the item. Similarly, if the consumer paid a deposit of £750, it would be sufficient to have £100 in trust (having paid the £300 to the supplier). With the additional payment of £450 from the customer on delivery, the costs would be covered.

10.12 However, this would not provide total protection. An administrator would only be willing to fulfil the order if there was a period of trading in administration, and if the supplier was still trading and willing to cooperate with the administrator. If the retailer's insolvency caused the supplier's insolvency (or vice versa), the trust would prove inadequate. Where an administrator was unable to fulfil the order, the money would be returned to the consumer, but would only partially satisfy the amount owed. In the latter example, only £100 would be returned to the consumer who had paid £750. The balance would be an unsecured claim.

10.13 There is an argument that this form of trust should be encouraged on the ground that something is better than nothing. Additionally, it might facilitate the supply of goods or services and consumers could have a better chance of obtaining what they ordered. Where it is not commercially feasible for the administrator or third party supplier to honour the prepayment, consumers would recover part of what they paid.

Standardised trust deeds?

10.14 In Chapter 6, we noted that the Trading Standards Institute takes a risk-based approach. For some business models, we think that it would be enough for traders to set up a "performance trust" designed to pay suppliers and perform the contract. We ask whether it would be useful to develop a standard trust deed along these lines, which business could adopt on a voluntary basis.

10.15 In many cases, however, we fear that trust arrangements would not be practical. As discussed in Chapter 8, we think that the particular problems of the furniture industry are so intractable that voluntary arrangements are unlikely to provide a solution. In Chapter 12, we consider preferential status for a limited category of consumer prepayments, which would address some of the issues raised by furniture deposits.

INSURANCE AND BONDING

10.16 The insurance market for consumer prepayments appears to be under-developed. While it could be used for gift vouchers and deposits, only a few insurers are willing to provide this and where insurance is offered it is often hedged with restrictions. Examples of these restrictions are to be found in some of the deposit insurance offered in the glazing industry.[4]

10.17 Bonds may be a more attractive solution, but we understand that they are unlikely to be sufficient to cover the entirety of consumer prepayments. Two particular issues were raised about insurance: the need to register and the lack of claims data. We look at each in turn.

Registration

10.18 Insurers will want to know that, if a retailer were to become insolvent, the insurer could administer claims without undue cost. There may well be a business need for consumers to register for protection, particularly in the case of gift vouchers, which are given from one person to another and where there is no central database of who holds them.

10.19 We think that there is merit in a registration system, provided that consumers can register easily (including online) and for free. However, it is important that registration requirements are not overly onerous (such as requiring registration by recorded delivery or within an unduly short period).

10.20 Some retailers expressed concern about any registration for insurance as it reminds consumers that gift vouchers and deposits are not necessarily secure. This however would be a bad reason for denying consumers the security which insurance brings.

Obtaining data

10.21 The main barrier to insurance appears to be the absence of claims data which insurers need to assess the risk properly. The problem is circular: without data, it is difficult to get insurance, and without insurance, there is no data. Furthermore, any single retailer seeking deposit insurance is likely to be treated with suspicion and/or charged an excessive premium.

[4] We give examples of some such restrictions at para 6.43.

10.22 We were told that the way of overcoming these obstacles would be for many retailers to act together to demand insurance arrangements, but it would need much stronger sector initiatives than have been forthcoming so far. The issue is particularly acute in the gift voucher sector, where it would be necessary for several large retailers to act together.

10.23 We welcome respondents' views on their experience of prepayment insurance and what can be done to overcome any barriers to it.

A CONSUMER CHARGE?

10.24 Standardised trusts would reduce legal costs but would still involve accountancy costs: money would have to be paid in and out of the ring-fenced account on a regular basis. Insurance and bonding arrangements rely on the development of market demand to make them truly affordable.

10.25 We have considered whether there are other mechanisms by which businesses can act voluntarily to give some creditors greater protection on insolvency but which do not involve putting money into trust or paying for insurance or bonding. The standard way in which businesses give creditors secured status is by granting a fixed or floating charge, which is then registered at Companies House. The mechanism of registering a charge with Companies House could be developed to provide a new and innovative means of giving secured status to certain classes of consumer claims on retailer insolvency.

10.26 To illustrate this possibility it may be helpful to set out an example of how such a charge could be used.

> A large supermarket runs a Christmas savings scheme: consumers buy points on their loyalty cards to be redeemed against a variety of Christmas deals. In the absence of protective measures, these "savers" risk losing their savings if the supermarket becomes insolvent. It is unlikely that the administrator would be able to honour all loyalty points - and would not be allowed to prefer consumers in the savings scheme over the general body of creditors.

10.27 Any supermarket running a scheme of this sort should be paying the savings club monies into a trust account, but we accept that this adds administrative costs. Furthermore, in this case, the receipts from the savings club would be such a tiny proportion of the supermarket's capital that there is no need to preserve the money. It would be enough to find a way to give a priority to this debt on a voluntary basis.

10.28 The proposal would be to set up a new statutory scheme, to allow a business to register a "consumer charge" with Companies House. The charge could be in favour of a specified group of consumers (such as those participating in a Christmas savings scheme) for specified debts (such as repayment of the savings). A consumer charge would be a first-ranking floating charge, which would rank below fixed charge holders and 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.[5]

10.29 The mechanism of how it works would need to be set out in statute to define the class of creditors and how it should be registered.

10.30 The practical effect on insolvency would be a priority for consumers over lower-ranking floating charge holders and other unsecured creditors, but the business would not need to put the money aside. There would be one-off costs of registering, but once registration was complete, the business would incur no further costs.

10.31 The consumer charge would be voluntary and its terms could be changed at any time to exclude future prepayments (but not to remove protection for payments already received and subject to the charge). However, the statute would need to set out publicity requirements, to ensure that consumer groups and media were aware that a business had stopped offering the protection of a consumer charge. We would hope that the adverse publicity would ensure that businesses thought carefully before withdrawing this protection.

10.32 A consumer charge would be a new development of current principles of floating charges and would need to be introduced by statute. Developing such a charge would be complex, and would involve a considerable amount of working out and negotiating with interested parties. We ask whether there would be a demand for such a voluntary legal instrument, which could be used to prefer consumers over the claims of floating charge holders and unsecured creditors.

[5] We consider the potential effect of giving consumers a priority on the cost of lending in Chapter 12 from para 12.40.

QUESTIONS

Q6 Would trusts designed to protect some rather than all prepayments (either where funds could be drawn-down, or where only some prepayments were put into trust), be an acceptable compromise in situations where ring-fencing all prepayments is not practical or affordable for the business?

Q7 Would it be useful to develop a series of standard trust deeds which businesses could use to protect consumer prepayments?

Q8 Do consultees have any experience of prepayment insurance? If so, we would be interested to learn more about:

(1) Cost of insurance and who bears this;

(2) Extent of insurance coverage and any limitations or exclusions which may apply;

(3) Claims procedure for consumers including documentation to be supplied;

(4) Interaction between insurance and section 75 claims (for example, whether consumers must first pursue a section 75 claim where available before making a claim under the insurance policy).

If applicable, we would also be grateful for sample policy documents.

Q9 What can be done to overcome barriers to consumer prepayment insurance?

Q10 Is there merit in developing a new statutory "consumer charge" to be registered at Companies House, which businesses could use on a voluntary basis to give priority to some specified classes of consumer claims?

CHAPTER 11
PROPOSALS AND QUESTIONS: A NEED FOR REGULATION?

11.1 There has been a long-standing debate over whether protection of consumer prepayments should be left to voluntary arrangements, or whether those arrangements should be underpinned by regulation. For the last 40 years, Government policy has been to encourage trade bodies to agree voluntary schemes to protect consumer prepayments in high-risk industries.

11.2 As we saw in Chapter 6, these have met with only mixed success. Consumer prepayment protection is a core criterion of the Consumer Codes Approval Scheme, run by the Chartered Trading Standards Institute. However, this has been a particularly difficult criterion for traders to meet.

11.3 Regulations have been introduced in some sectors. The main example is the travel industry, where the Package Travel Regulations 1992 require operators to protect consumer payments in one of three ways: through a bonding scheme run by an approved trade body bonding; through insurance; or through trust arrangements.[1] Another example relates to prepaid funerals. Since 2002, those providing funeral plan contracts are subject to supervision by the Financial Conduct Authority, unless the firm makes suitable arrangements to protect the prepayment.[2]

11.4 We start by summarising the arguments which have been made for and against regulation. We also consider whether regulation should be introduced in potentially high-risk sectors. We make proposals and ask for views.

THE ARGUMENTS FOR AND AGAINST REGULATION

The arguments for regulation

11.5 The main criticism made of voluntary schemes is that action is only taken by good businesses. These efforts are then undermined by less scrupulous businesses. We have seen that codes approved by the Chartered Trading Standards Institute under its Consumer Codes Approval Scheme, for example, only attract a proportion of the market. Companies which face difficulties may decline to join or (if they have joined) leave the scheme. Similarly, voucher intermediaries which are financially strong are far more likely to ring-fence consumer prepayments than those which are not well capitalised.

11.6 The other argument against voluntary schemes and in favour of regulation is that, without strong Government intervention, little progress will be made. In Chapter 6, we listed several examples of failures to act. As we discussed in Chapter 10, concerted action is needed to break through the barriers to obtaining insurance.

[1] The full title of these regulations is the Package Travel, Package Holidays and Package Tours Regulations 1992. They are described in detail in Appendix D.

[2] See from para 6.57.

11.7 Encouraging such action may require at least the threat of regulation if not regulation itself. In 1984, the Office of Fair Trading (OFT) suggested that, if voluntary arrangements fail, regulators may need statutory powers to require firms to protect prepayments.[3] Consumer Focus has also argued for reserve powers:[4]

> 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.

11.8 Regulation might also be necessary to give retailers the impetus to take steps to formalise any existing efforts to segregate consumer funds, such as introducing trust arrangements to protect money currently held in separate accounts of the company.

The arguments against regulation

11.9 In 2006, the OFT argued against regulation of all prepayments made by consumers, as prepayments were "an important component of the way the economy works":[5]

> Many businesses depend on prepayments to provide working capital and some might not be able to start up if the compliance costs were too great. It is likely that these costs would ultimately be passed on to consumers. There are also the enforcement costs to consider and the decision as to which body should oversee this.

11.10 The OFT also argued against specific regulation of the Christmas hamper sector. First, it was said to be difficult to target high-risk businesses: any attempt at definition might include some relatively low-risk businesses. Any definitions could invite "either evasion or unintended consequences".[6] Furthermore, singling out hamper schemes would do nothing to address the problems "when the next furniture retailer or other business which accepts a significant level of prepayments goes out of business".[7]

[3] Office of Fair Trading, The Protection of Consumer Prepayments: A Discussion Paper (1984) paras 7.4 and 7.9.

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

[5] Office of Fair Trading, *Farepak: review of the regulatory framework* (December 2006) para 7.

[6] Above, para 9.

[7] Above, para 60.

11.11 The OFT thought that the costs of protecting savings in hamper businesses could be prohibitive. It argued that the industry needed working capital, so it was unrealistic to expect businesses to put money into a ring-fenced account. Insurance and bonding schemes would be costly, given the risks now associated with the market. Furthermore, prescriptive regulation, for example requiring agents to run separate client accounts, would be unattractive to agents and costly to consumers.

11.12 Compliance with regulation may in itself be expensive. In Chapter 7, we saw some of the complexities associated with the Electronic Money Regulations 2011. One of the consequences of operating a regulated electronic money product is that the costs of operating in the regulated environment may be passed on to the consumer. We were told of examples where the holder of a regulated gift card is charged a monthly service or "dormancy" fee after a period of inactivity, which will gradually reduce the balance to zero over time.

Balancing these arguments

11.13 We acknowledge the argument that the Government should encourage prepayment protection in those areas which pose the greatest risks. This would encourage more concerted industry action to break through the barriers to obtaining insurance and would protect consumers against practices shown to cause them particular detriment. On the other hand, as the OFT pointed out, it is often difficult to define high-risk sectors. Further, we agree that regulation should not impose undue costs or bureaucratic requirements on well-run businesses.

11.14 With this need to strike a balance in mind, we consider the two areas of particular consumer detriment identified in Chapter 3: gift vouchers, and deposits for furniture and home improvements. We are interested in two issues.

(1) Is it possible to identify risk factors, so that any regulation can be targeted at those areas posing significant risks?

(2) In those sectors, can measures be used to protect prepayments which do not impose undue costs and bureaucracy on the firms involved?

11.15 We think that sector-specific regulation should only be considered if it can be targeted appropriately at high-risk areas and introduced without undue cost.

THE VOUCHER SECTOR

Voluntary protection in most cases

11.16 When insolvent retailers are unable to allow redemption of gift vouchers, consumers suffer detriment. It was put to us that all gift vouchers should be backed by trusts. Otherwise, the consumer is simply buying a low-grade debt at face value without either discount or interest.

11.17 We do not agree that all gift cards and vouchers should be regulated. For most retailers, our research suggests that the level of potential detriment is relatively small in comparison with the size of the market, which is now worth £5.4 billion.[8] As we saw in Chapter 3, in the majority of cases administrators honoured vouchers during a period of trading in administration, in order to preserve consumer goodwill and the commercial value of the brand, encourage consumers to spend in-store, or to avoid negative press coverage. This makes vouchers from well-known retailers, or from retailers who hold stock, relatively low-risk.

11.18 Furthermore, when consumers do lose money, it appears that they typically lose small and affordable amounts. In the case of Zavvi, for example, the average value of vouchers held by consumers was only £8.12.

11.19 We fear that the regulation of all gift vouchers would impose a significant burden on a wide range of businesses, including small and medium enterprises. Vouchers are not just issued by high street stores. Small firms, from florists to butchers, can and do issue vouchers. These businesses might find administering trust accounts or applying for insurance to be particularly burdensome.

11.20 However, we urge retailers to do more to protect vouchers on a voluntary basis. As we argue in Chapter 7, the voucher industry will only thrive if consumers have confidence in it, and that confidence could be undermined by one or two major insolvencies. In Chapter 10, we explore ways to make voluntary protection easier.

11.21 Unsurprisingly, consumers appear to have a low awareness of the Electronic Money Regulations 2011, and may have little idea about whether vouchers are protected. We would wish to increase consumer awareness in this area. We think that providers of vouchers should state in the terms and conditions whether or not any protection is in place in the event of insolvency. We ask whether this can be introduced voluntarily or whether it would require regulation.

A case for regulation in higher-risk sectors?

Risk factors

11.22 Four factors increase the risk of detriment to prepaying consumers:

(1) Consumers pay significant sums.

(2) Sums are held for a relatively long period of time.

(3) Consumers find it difficult to obtain redress from their debit or credit card issuer: either because they have paid by other means; or because the payment was made to one intermediary and passed to another; or because the person who bought the voucher is not the holder of it.

(4) The company holding the funds does not predominantly sell other goods and services and will therefore be unlikely to trade in administration.

[8] UK Gift Card & Voucher Association, *Gift Cards & Vouchers in the UK – Summary 2014,* http://www.ukgcva.co.uk/downloads/factsheets/summary_2014.pdf.

11.23 We discuss two scenarios in which these factors are present. The first is savings schemes, typically for Christmas, where consumers pay for vouchers and goods in advance as a form of saving. We think that there is an argument for introducing some form of regulation for these schemes because they are, in essence, savings products.

11.24 The second is the business model where the retailer's main business is the sale of gift vouchers which can be redeemed with third-party suppliers. We call this the "intermediary model". Many voucher intermediaries take steps to reduce the risk of insolvency through prudential accounting standards, holding funds in low-risk investments and, generally, not using money supplied by consumers for other purposes. However, where these measures are not in place, the intermediary model poses greater risks. We think there is an argument for the Government taking reserve powers here, to be used if and when there is evidence of demonstrable need.

Savings schemes

11.25 The biggest consumer losses in recent years arose when Farepak collapsed in 2006, owing £38 million to consumers who had been saving for Christmas. The issue caused great public concern – MPs received huge amounts of correspondence on the issue. The savers waited six years for payment and eventually obtained around 50 pence in the pound (though 70% of this came from compensation funds set up to meet hardship, rather than through a distribution from the insolvency).

11.26 Christmas and similar savings schemes are high-risk: funds are typically held for a relatively long time and tend to represent significant amounts for the consumers concerned. Consumers who are saving money expect protection. This is provided to those who are saving with financial institutions. However, Farepak was not subject to regulation because consumers received vouchers rather than cash returns.[9]

11.27 Several Christmas savings schemes continue to exist. Some are voluntarily members of the Christmas Prepayment Association with trust arrangements in place.[10] However, others (particularly supermarkets) have no such arrangements. While some do take steps to segregate consumers' money in a separate company account, this would not protect consumers in the event of insolvency. Given the size of the Farepak insolvency, and the public anger it caused, this is worrying.

[9] A comparison might be drawn with "layby" sales in New Zealand, where goods are paid for in instalments and only delivered when payment has been made in full. These have a statutory priority on insolvency. See para 12.6 for further discussion.

[10] For a list of members of the Christmas Prepayment Association, see http://www.cpa-advice.co.uk/members.htm.

11.28 In many sectors of the economy, businesses need to rely heavily on consumer prepayments for working capital – but we do not think that Christmas savings schemes are one of them. We disagree with the OFT on this point. Members of the Christmas Prepayment Association already hold prepayments on trust. Supermarkets, which do need working capital to service other parts of their business, are nevertheless sufficiently large and well financed that their working capital does not need to come from savers' money. This is illustrated by the fact that some already segregate consumer funds, and the fact that the Co-operative holds the money on trust as discussed in Chapter 10. Supermarkets benefit from Christmas savings schemes because it increases their sales. In our view, non-regulated businesses should not be operating savings schemes to obtain money to finance other operations.

11.29 Where people put their money in savings clubs, or in products which are marketed as savings schemes, they expect their money to be protected. This protection is already in place where consumers save with financial institutions. However, the schemes we are concerned with take prepayments for products, services or vouchers and do not return cash to consumers in the way that banks and building societies do.

11.30 We do not propose that such savings clubs should be regulated as financial institutions, which would be onerous and disproportionate. However, it is often the most financially vulnerable who choose these alternative forms of "saving" and we do not think that these types of schemes should be entirely unregulated. We think that the Farepak case demonstrates a need for Government intervention in the sector.

How would a savings scheme be defined?

11.31 These non-regulated savings schemes may take different forms. They may, as Farepak did, take monetary instalments in return for goods and vouchers provided at the end of the saving period. They may take the form of gift or loyalty cards which can be loaded up over time.

11.32 We think that the main mischief is marketing a scheme as a form of savings mechanism without providing any protection for the money taken. There are many different words which imply that a scheme is suitable for savings. For example, one travel company advertises its gift cards as "a great way to save" towards a special holiday, while a toy shop markets a "piggy bank" re-loadable gift card for children. Christmas schemes may be described as "helping families budget for Christmas" by paying "small regular amounts throughout the year".

11.33 We think all these forms of words suggest that the scheme is suitable for use as a savings vehicle. The definition should catch anything marketed or structured in a way that implies it is suitable as a savings scheme.

What form would the regulation take?

11.34 We provisionally propose that firms should be prevented from marketing or structuring a scheme in a way which suggests that it is suitable as a savings vehicle, without protecting the funds in some way. We think that this should constitute a form of misleading action, similar to other misleading actions within the Consumer Protection from Unfair Trading Regulations 2008.

11.35 Clearly, financial institutions already take sufficient steps to safeguard funds. For other schemes, we do not suggest that traders would need to be authorised by the Financial Conduct Authority, or be subject to anything like the same form of regulation. We envisage that the main form of protection would be holding money on trust. We do not think that this would impose great costs on businesses: those which are part of the Christmas Prepayment Association will already have protections in place, and other businesses should be able to segregate such funds easily as they will not generally rely on them for working capital. We also envisage that firms would be allowed to choose alternative protections if they preferred, such as insurance, bonding or the consumer charge discussed in Chapter 10.

11.36 We seek views on this proposal. We are particularly interested in whether our definition is correctly targeted, and in how far the proposal would impose additional costs.

Voucher intermediaries

11.37 There are several different types of voucher intermediary involving different degrees of risk depending on the precise nature of the business model employed.

11.38 In Chapter 7, we discussed the problems in defining electronic money. The Electronic Money Regulations 2011 apply to "open loop" cards which can be redeemed at a range of retailers for a range of goods. Examples include the Love2Shop gift card and travel currency cards. These cards must be backed by ring-fenced funds. However, there is an exception for "limited network" cards, which can be redeemed from a limited category of retailers, or from a wide range of retailers but for a limited category of products. Book tokens, and spa vouchers redeemable at a number of different spa locations, are well-known examples. While open loop cards are subject to considerable regulation, limited network cards are not.

11.39 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. In these cases, the consumer is usually directed to a specific provider of the relevant goods or services which is separate from the company which takes payment for the vouchers.

11.40 In all these cases, the funds tend to be held by an intermediary until the voucher is used. Importantly, because they do not hold stock, intermediaries are less likely to trade while in administration, and retailers or other third party suppliers may well stop accepting vouchers which the intermediary had issued. They are also less likely to involve well-known brands which administrators and future purchasers will wish to preserve by accepting vouchers.

11.41 In para 11.22, we identified risk factors. The first is that consumers pay significant sums. Examples where the consumers may pay significant sums to intermediaries are vouchers for experience days or theatre tokens. In these cases the intermediary issues a limited network card or voucher, possibly for £100 or more, which can be redeemed from a range of suppliers.

11.42 The second is where these vouchers are held for a relatively long time. For example, vouchers may be sold for Christmas or Valentine's Day and redeemed during the summer, when outdoor experiences are more attractive. This contrasts with distributors who organise "gift card malls",[11] which hold money for only two or three weeks before passing it to the retailer involved.

11.43 The risks of holding significant sums, or holding sums for relatively long periods, would not be sufficient to justify regulatory intervention on their own. Indeed, there are few examples of such intermediary models becoming insolvent and causing loss to consumers. In the only case we have identified, Red Letter Day, loss to consumers was avoided because new purchasers of the business agreed to honour vouchers.[12] However, the business model can pose particular risks, if firms were to take significant funds, owe liabilities for a long time, use funds for other purposes and fail to provide consumers with any form of protection.

11.44 The OFT was right to draw attention to the problems of definition. There are many different business models which constitute intermediaries and we have considered whether some pose greater risks than others.

Lower-risk intermediaries

11.45 If intermediaries were to introduce the protections we outline in Chapter 10, this would improve the outcome for consumers on insolvency. However, this may not be practicable. Intermediaries are unlikely to be able hold 100% of all voucher sales on trust as they have no other income streams to fund the operation and marketing of the business. Additionally, the lack of prepayment insurance products may mean that this is a costly solution for intermediaries whose business model yields very small margins (which may be 1% to 2% of the voucher amount). Finally, a statutory priority or a voluntary priority (by way of consumer charge) may be of little use here as the insolvency of the business will usually mean that the funds have been depleted.[13] Unlike in the case of high street retailers, there is also less likelihood of there being secured creditors over whom a priority could be asserted.

11.46 While we would welcome the use of trusts (along the lines outlined in Chapter 10 whereby a proportion of the funds could be used for the costs of running the business) and the development of insurance products, we are aware of the difficulties these may pose in practice. We are therefore interested in finding out more about the steps intermediaries take to manage funds they hold in a prudent manner, thereby decreasing the risk of the business becoming insolvent in the first place.

[11] These are stands in retail outlets (and online) where consumers may choose from dozens of gift cards for different retailers.

[12] See para 7.28.

[13] In situations where the insolvent retailer has assets such as stock, leaseholds and other sales revenue, these may be realised for the benefit of creditors. In the case of voucher intermediaries, where the main asset is a reserve of cash, this is less likely.

11.47 Many companies which use the intermediary business model work already take active steps to protect their cash reserves. In particular, they:

(1) have high liquidity and hold cash balances, or low to medium risk investments, in excess of the value of the vouchers they expect to be redeemed;

(2) have rigorous accounting standards and prudent models for calculating breakage;[14]

(3) do not have secured lenders as their business model does not require external funding;

(4) do not invest funds in high-risk ventures or use funds for other purposes, and have independent investment committees to ensure this.

11.48 Furthermore, some voucher intermediaries (including National Book Tokens, Theatre Tokens and National Garden Gift Vouchers) are run on a not-for-profit basis and so are not under the same commercial pressures to use funds for other purposes.

11.49 We believe that businesses which reduce the risk of insolvency by handling consumer funds in the manner described above already mitigate the risks inherent in holding voucher proceeds for an extended period of time. We do not wish to impose any additional regulatory burden on these firms, and hope that this kind of behaviour could be further encouraged. We would welcome any voluntary accreditation scheme, led by industry, which allows those who adopt prudent financial behaviour to make this known to consumers.

High-risk intermediaries: a need for regulation?

11.50 However, the situation is different where intermediaries do not adopt the above measures and expose the funds they hold to risk. With a significant amount of funds at their disposal and no immediate obligation to repay it, intermediaries may seek to maximise returns on investments for shareholders, to further expand their business, or to recognise revenue from the sale of gift vouchers as immediate profit.

11.51 The problem is that anyone may start an intermediary business by issuing vouchers for significant sums to be redeemed within a limited network of suppliers many months later. Unlike those who fall within the Electronic Money Regulations 2011, such intermediaries are under no obligation to segregate or account for the funds they receive from consumers. Instead, an intermediary selling such vouchers may use its funds for any purpose, including buying another business, lending the money to another member of the group, or expanding its business through advertising.[15]

[14] Breakage is the trade term for the level of vouchers which are never redeemed.

[15] There is nothing in law to prohibit intermediaries from using the funds as they see fit.

11.52 This is unsatisfactory. While we hope that all businesses will be able to lower risk by adopting the measures we discuss in paragraph 11.47, we think that there may be a case for requiring intermediaries to protect deposits where high-risk behaviour continues.

11.53 We think that legislation should provide the Government with a reserve power to regulate in this area, if the need arises. This would permit the Government to require high-risk voucher intermediaries to hold money on trust, or to protect prepayments in other ways, for example through insurance or bonding.

11.54 At present, we propose only a reserve power. This would identify risk factors in general terms. Clearly, before using such a power, the Government would need to consult carefully on the details of the definitions and on the impact of the regulation. We would not wish to impose additional costs on well-run businesses and would welcome the emergence of industry standards which reduce the risk of insolvency.

DEPOSITS

11.55 The scale of potential consumer detriment and hardship is greater where consumer prepayments take the form of deposits rather than gift vouchers. As we saw in Chapter 3, the value of a deposit tends to be higher than the value of the average gift voucher. In addition, they are more likely to have been paid by the consumer for their own benefit rather than as a gift. However, options for prepayment protection are particularly limited where retailers legitimately rely on funds received for working capital in order to service the orders on which the deposits have been paid.

The furniture and home improvement sector

11.56 We have identified the furniture and home improvement sector to illustrate the difficulties which arise in protecting consumer deposits.[16] In Chapter 3, we identified eight major insolvencies in this sector from 2008 to 2014, which had taken consumer prepayments totalling around £56 million. Consumers risked losing large amounts. As the evidence provided by Citizens Advice showed, this can cause hardship. It can also cause significant public anger.

11.57 Unfortunately, the history of voluntary protections in this sector is one of failure. Businesses rely on high deposits for working capital and cannot afford to ring-fence the money in trusts. Furthermore, given the track record of the industry, it has proved particularly difficult to insure furniture deposits.

[16] See Chapter 8 for an explanation of the particular risk factors in this sector.

11.58 In 1990, an OFT report on problems in the furniture sector recommended that retailers should take steps to establish and publicise payment protection schemes. The OFT "expected" the National Association of Retail Furnishers and individual retailers to indicate within six months what steps they proposed to take to establish such schemes.[17] Yet, 25 years later, only limited progress has been made.

11.59 Under the TrustMark scheme, some major retailers have an insurance scheme to protect those cases in which they take deposits. In Chapter 6, we note that the Furniture Ombudsman is applying to the Trading Standards Institute to approve a code which would include consumer prepayment protection. However, such prepayment schemes could be onerous and there is a risk that only a minority of its members would sign up to such a voluntary code.

11.60 Furniture retailers who take prepayments clearly present a high-risk and we have therefore considered whether sector-specific regulation might be practical or justified. However, we remain pessimistic that measures could be used to protect prepayments without imposing undue costs and bureaucracy on the firms involved. We do not think that trust, insurance or bonding arrangements are likely to be widely adopted in the furniture industry. Businesses need deposit money for working capital, and the risks are likely to make insurance costly. These problems would make it difficult to introduce regulation for this particular sector. We seek views on this issue.

A different approach

11.61 We think that a different approach is needed in order to address the problems of retailers who take large deposits. In the following chapter, we consider the possibility of a limited change to the rules governing the priority of creditors' claims in insolvency.

[17] Office of Fair Trading, *Furniture and Carpets: A report by the Director General of Fair Trading* (February 1990) para 5.9.

PROPOSALS AND QUESTIONS

Proposal 4 Rather than introducing mandatory prepayment protection for all gift vouchers, retailers should be encouraged to take more voluntary steps to protect consumers.

Q11 Do consultees agree?

Proposal 5 Providers of vouchers should state in the terms and conditions of the voucher whether or not the value of the voucher is subject to any protection in the event of insolvency.

Q12 Do consultees agree? Could this be introduced voluntarily, or would it require regulation?

Proposal 6 It should be unlawful to market a scheme in a way which suggests that it can be used as a savings vehicle without putting some form of protection in place to protect the funds.

Q13 Do consultees agree?

We welcome additional comments on this proposal. In particular:

(1) Is our definition correctly targeted?

(2) What additional costs would our proposal impose?

Proposal 7 Legislation should 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 alternative protection.

Q14 Do consultees agree?

Q15 What would the risks and potential costs be for any voucher intermediary (whether "high-risk" or not) if they were required to introduce protection mechanisms such as trusts, insurance or bonding?

Q16 Do consultees agree that sector-specific regulation is not a suitable means of protecting consumer prepayments in the furniture and home improvement sectors?

CHAPTER 12
PROPOSALS AND QUESTIONS: LIMITED PREFERENTIAL STATUS FOR CONSUMERS

12.1 When a retailer becomes insolvent, many different creditors will lose money. The issue of whether some should lose more than others is a difficult political decision, which involves allocating loss between equally innocent parties.

12.2 In Chapter 2, we set out the current statutory hierarchy of creditors' claims on insolvency, which gives consumers a low status as unsecured creditors. There has been considerable controversy as to whether this should be changed. 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.

12.3 On the other hand, the Cork Committee recommended sanctions against directors who took consumer prepayments knowing that the company's financial difficulties were such that it might not be able to deliver the goods, and without putting the funds in trust. The actual provisions on wrongful trading which were subsequently introduced are much more limited than this, as we discussed in Chapter 4.

12.4 The argument for giving prepaying consumers preferential status has been put by the Office of Fair Trading (OFT) and by Consumer Focus. Such consumers do not possess the same information or commercial awareness as other unsecured creditors and do not understand the risk they are taking. The OFT and Consumer Focus argued that money taken from unsuspecting consumers should not be used to repay a company's other debts or fund its business model.

12.5 Consumers in the United States are granted a priority over other unsecured creditors for claims arising from the deposit of money in connection with the purchase, lease, or rental of property, or the purchase of services, for personal, family, or household use, that were not delivered or provided (subject to a maximum of $2,775).[1]

[1] 11 US Code § 507(a)(7). The maximum amount stated in the text is $1,800 but this is adjusted every three years. The last adjustment, to $2,775, was made on 1 April 2013.

12.6 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.[2] The New Zealand Law Commission considered the justification for this priority and concluded that it should be retained. They argued that the law should encourage prudent budgeting and that those who elected to use the layby system tended to have modest means and therefore could least afford to lose the money. They also thought that the amounts at issue in relation to preferential claims based on layby sales would generally be low and therefore unlikely to impact unduly on dividends received by other creditors.[3]

12.7 We do not think that all consumer claims should be given preferential status. Many claims are small, which means that they are expensive to distribute and failure to satisfy them will not cause much hardship. Some types of debt, such as damages for faulty goods, are also particularly difficult to assess. 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.

12.8 However, we think that there is a case for giving preferential status to a small and limited category of the claims of consumers who have prepaid. This is where businesses take significant sums of new money from such consumers shortly before entering insolvency and no other protections are in place.

12.9 Our proposal would address many of the most serious issues in the furniture and home improvement industry, but it is not intended to be limited to that sector. It would apply to all company insolvencies as a safety net where other protections prove insufficient.

12.10 We start by setting out the proposal. We then examine the arguments in support of it.

THE PROPOSAL

12.11 We propose that consumers should have preferential status if their claims meet **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] Layby Sales Act 1971, s 11(1).

[3] New Zealand Law Commission, *Priority debts in the distribution of insolvent estates: an advisory report to the Ministry of Commerce* (October 1999) pp 46 and 47. In the Australian context, an argument is made for a new consumer priority in C Symes, *Statutory Priorities in Corporate Insolvency Law* (2008) ch 8. This also contains a brief comparative discussion looking at consumers' position on insolvency in the UK, the United States, Canada and New Zealand.

(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. The preferential status would be limited to the value of the prepayment.

(3) The payment is made **during the months** leading up to insolvency, when the financial problems facing the company are likely to become apparent. We have considered whether this should be a flexible test, but are inclined to think it would be simpler to have a set time limit. We ask whether preferential status should only be awarded to prepayments made in the three months before the company enters administration or liquidation.

(4) The **claim is sufficiently large** to justify the costs of distribution. The point was put to us strongly by the Institute of Chartered Accountants in England and Wales (ICAEW) and others that the cost of making small distributions can be quite disproportionate. Our provisional view is that 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. We seek views on this figure.

(5) The consumer **used a payment method which did not offer a chargeback remedy**. In other words, it would not cover payments by credit and debit cards, but would be limited to other payment mechanisms such as cash, cheque or online bank transfer.

12.12 Our proposal is that this limited category of claims should have preferential status, behind preferential claims from employees but before floating charge holders. This proposal would not give such consumers full protection: there may be no funds available. However, it would protect consumers in the great majority of cases we looked at where funds were available and paid to secured creditors.

12.13 As we discuss below, the impact of this proposal would be felt by secured creditors who lend to businesses which take large cash deposits. Secured lenders would need to monitor such deposits carefully. However, since only a small minority of retailers take large cash deposits, we do not think that it would raise the cost of borrowing for retailers generally.

THE ARGUMENTS

12.14 Three arguments can be made in favour of giving preferential status to these 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;

(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.

12.15 We look at each in turn.

Hardship

12.16 As Consumer Focus pointed out, buyers paying by cash and cheque are particularly likely to be financially vulnerable.[4] The protections of section 75 and chargeback are therefore less likely to be available to those consumers who are least able to afford to lose money.

12.17 A report compiled for us by Citizens Advice provided examples of hardship, taken from telephone calls to the Consumer Service[5] and from Bureau Evidence Forms. As discussed in Chapter 3, these included an elderly man who paid £6,000 for a bathroom by cheque; a low income family on income support who paid £981 for a sofa and arm chair; and a family with a disabled child left without the freezer they had paid for. Many clients emphasised the stress this caused. As one consumer put it:

> We are very stressed - we may have lost over 3 grand. Our home is incomplete because we cannot afford to purchase any more as we have no funds left.

12.18 However, we do not think that hardship alone, without the other factors discussed in this section, would be a sufficient reason to introduce preferential status for these claims. Many trade creditors may also be vulnerable (such as unpaid contract cleaners, or self-employed van drivers) and could make an equal case for preferential status, if that was to be awarded on the basis of hardship alone. We only make this proposal because the other arguments also apply.

Inability to assess risk

12.19 We think that prepayments are different 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.

12.20 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.

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

[5] The evidence was both from Citizens Advice Consumer Service and its predecessor, Consumer Direct.

> 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.
>
> Client feels he was misled because [trader] went into liquidation that day and no one told him.

12.21 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 would never be supplied. The consumers provided the money in ignorance of the risks.

12.22 In this, cash-paying consumers differ from card-paying consumers. Consumers who pay by credit and debit card cannot assess insolvency risk themselves, but they 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, at a card issuer's request, through chargeback. Effectively, they can act as proxies for consumers, assessing and responding to insolvency risk, in a way which consumers are not able to do individually.

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

12.24 One reason for singling out cash-paying consumers is that this group (typically the least financially sophisticated) are unable to assess the insolvency risk or take alternative action: nor does anyone else take this action on their behalf. They are unprotected.

Perverse incentives

12.25 The Cork Committee recommended greater protections where company directors were aware of financial difficulties and continued "to accept payments in advance ... without paying the money into a trust account".[6]

12.26 Trading standards officers referred to this process more colloquially as "busting out": that is, the desperate search by a business on the verge of insolvency for new money, typically from consumers who are ignorant of the problems. These businesses may be subject to large "hold backs" from their merchant acquirers so may persuade consumers to pay by cash or cheque instead. 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".

[6] *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558, para 1056.

12.27 The Cork Committee thought that such behaviour was evidence of wrongful trading for which the directors should be held liable.[7] This is not the current legal position. As discussed in Chapter 4, wrongful trading actions are extremely difficult to bring, and present a high hurdle for claimants to overcome. Courts will also be reluctant to disqualify directors who are simply doing their best to avoid insolvency. Directors will not be criticised for accepting consumer prepayments knowing that goods or services may never be delivered, provided that there is a reasonable prospect of avoiding insolvency.

12.28 In both the World of Leather and Farepak insolvencies, considerable public anger was expressed against directors and the banks, because the companies continued to take payments from vulnerable consumers after financial problems became apparent but had not been made public. In the case of World of Leather, the court held that the directors had not shown themselves to be unfit to hold directorships. In Farepak, the Secretary of State dropped the proceedings.

12.29 However, in Farepak, the judge did criticise the group's bank, HBOS.[8] Although the bank had acted in accordance with the law, it responded to this criticism. Lloyds Banking Group, which acquired HBOS, contributed an additional £8 million to the distress fund for Farepak customers, beyond the £2 million already pledged.

12.30 As we discuss in Chapter 4, we do not think it is possible to draw a clear line of what does or does not constitute wrongful trading. Directors have every reason to try to avoid insolvency: it is human nature that they may continue their efforts to save their companies for too long. Similarly, creditors who are about to lose money will tend to focus narrowly on getting "their money" back, often at the expense of other creditors. We do not think that it is helpful to place blame on individuals who act in this way.

12.31 However, we are concerned about a body of legal rules which allows floating charge holders to benefit from additional deposits taken 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.

12.32 Any change of this sort would be significant and would involve a considerable amount of consultation and negotiation with affected stakeholders.

IMPACT OF THE PROPOSAL

On the furniture and home improvement sector

12.33 The proposal is not in any way confined to the furniture and home improvement sector, but we think that this is the sector where it will have the greatest impact.

[7] Above, para 1056.

[8] We discuss this case, including the judge's comments about HBOS, from para 4.47.

12.34 We expect that, in most 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.

12.35 Our proposal is designed to encourage a greater range of orders to be fulfilled, even where the consumer has paid a large deposit in cash and the payment to the supplier may reduce the amount available to the secured creditors. If, for example, a consumer has paid £1,000 for a sofa which it costs the retailer £500 to supply:

(1) 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.

(2) If, however, the consumer's claim of £1,000 was preferential, the administrator would be able to exercise commercial judgement on this issue. It will often be cheaper to pay the £500 to fulfil the order and extinguish the preferential claim, rather than pay the £1,000 to the consumer.

12.36 We were told that for consumers who paid by credit and debit cards, the merchant acquirer may provide funds to allow orders to be delivered, as this reduces the ultimate chargeback claims. We hope that in many cases our proposal would allow orders in the pipeline to be delivered during a period of trading in administration in an orderly and cost-effective process.

On the gift voucher sector

12.37 By contrast, this proposal will have a limited impact on vouchers. Most vouchers have a face value of less than £100, and may well be held for more than three 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.

12.38 Of course, there may be cases in which a consumer has paid for a voucher of more than £100 in cash within three months before insolvency – and in these cases the provisions would give the consumer who made the purchase a preferential claim. Given that vouchers change hands, however, it may be difficult in practice to establish when and how the voucher was bought, and by whom.

12.39 We seek views on whether it would be possible for retailers to keep records to identify gift vouchers of £100 or more bought with cash, and to present a running total of such sums to their floating charge holders.

On floating charge holders

12.40 Our analysis of high street insolvencies suggests that the impact of this proposal would fall predominantly on floating charge holders. We do not think the impact would be great, as the category of claims given preferential status is very limited. It would only bite in those few businesses which take large deposits by cash or cheque.

12.41 In terms of outcome for the floating charge holder, the effect of the preferential status would be similar to holding the money on trust (which already occurs and is accepted by floating charge holders as good business practice). The difference is that this proposal would apply even in poorly run businesses which failed to make the trust arrangements properly or at all, operated trust arrangements badly, or required the funds for other working capital.

12.42 In these cases, it would make floating charge holders more cautious in their lending practices. Lenders would need to focus on the underlying strength of the business, and its general asset base, rather than securing their lending on consumer deposits. We think that this caution would be beneficial. Below, we ask whether the monitoring arrangements would present any practical difficulties.

12.43 That said, we have only looked at businesses which went into administration – not those which avoided it. We would be interested to hear about businesses which successfully traded their way out of financial difficulties. In particular, did consumer deposits by cash or cheque play a role in that process?

On unsecured creditors

12.44 In the majority of the cases we examined, there was no return to unsecured creditors, outside the prescribed part. Granting consumers a preference would therefore have had no impact on the outcome to other unsecured creditors. The only, marginal, effect would have been a small reduction in the number of claims on the prescribed part, thereby allowing a small increase in payments to other unsecured creditors.

12.45 However, for some small and medium businesses without secured creditors, the impact of the proposal would be felt by other unsecured creditors. We are interested in examples of such insolvencies.

DETAILS OF THE PROPOSAL

12.46 We propose that a limited category of consumer claims should be given preferential status, to rank behind employees but in front of floating charge holders. Preferential status would apply where the consumer provided a significant sum of new money to the business in the run-up to the insolvency, using a payment method which did not offer a chargeback remedy or other similar protection (section 75).

12.47 We seek views on the detail of this proposal. In particular, how should the "run-up to insolvency" be defined, and what should be considered "a significant sum"?

Defining the "run-up" to insolvency?

12.48 The mischief which this proposal seeks to address is that money was taken from consumers at a time when secured lenders and others were aware that the firm faced financial difficulties but consumers were ignorant of them.

12.49 One possibility is that this should be a flexible test: administrators should assess when the financial difficulties were or should have been apparent to the floating charge holder. Preferential status should only be awarded to money paid after this date. While this approach has some attractions, we are inclined to think that it would be too difficult to apply in practice. Administrators need a clear cut-off point.

12.50 Citizens Advice has highlighted that many consumers are persuaded to part with cash and cheques shortly before insolvency. The proposal would have a beneficial effect even if it was confined to a short period before the retailer enters administration - say four weeks. On the other hand, many furniture and home improvement retailers work on a three month cycle. If the aim is to encourage administrators to deliver the goods which have been ordered, it would be better to include all consumer payments within a three month period. This is our provisional view.

12.51 We therefore seek views on whether the proposal should apply to prepayments received within the three months before the date in which the firm entered administration.

Defining "a significant sum"?

12.52 Preferential status should only be awarded to claims which are sufficiently large to justify the cost of the distribution. Again, we favour a clear, certain test. Our provisional view is that 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). We seek comments on this figure.

PROPOSALS AND QUESTIONS

Proposal 8 A limited category of consumer claims should be given preferential status, to rank behind employees but in front of floating charge holders. It would apply where the consumer provided a significant sum of new money to the business in the run-up to the insolvency, using a payment method which did not offer a chargeback remedy.

Q17 Do consultees agree with the policy behind this proposal?

Q18 Do consultees agree that the preferential status should apply to money paid within a set period before the date of entering administration/liquidation? We seek views on whether that set period should be three months.

Q19 Do consultees agree that preferential status should be limited to claims where the consumer has paid more than a certain amount, either in a single transaction or in a series of linked transactions? We seek views on whether that amount should be £100.

Q20 We seek views on the impact of this proposal generally. We are also interested in the following issues:

(1) Are retailers able to keep records of prepayments of (say) £100 or more made by cash or cheque, so as to present a running total of such sums to their floating charge holders?

(2) Would floating charge holders be able to monitor these sums?

(3) Do many businesses rely on these prepayments to a significant degree?

Q21 We are interested in hearing about examples of businesses:

(1) which rely on these prepayments but do not have secured creditors; and/or

(2) which successfully traded their way out of financial difficulties by relying on consumer deposits by cash or cheque.

CHAPTER 13
PROPOSALS AND QUESTIONS: TRANSFER OF OWNERSHIP

13.1 In Chapter 2, we considered when ownership in goods passes to the consumer. Citizens Advice has provided us with evidence that consumers sometimes think their goods are ready for collection, only to be turned away when they go to collect them. 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. [Trader] has made so much money taking orders and not fulfilling them.

13.2 Consumers also expressed anger when they saw similar goods to those they had paid for being offered for sale during a period of trading in administration or where a subsequent purchaser took over the brand. In some cases, consumers were invited to pay for the item again.

13.3 In this chapter, we consider ways in which the rules on transfer of ownership in goods could be simplified, so as to operate more consistently and more fairly towards consumers in the event of retailer insolvency. We use the more modern terminology of "transfer of ownership" in most cases, but refer to the "passing of property" (the term used in the Sale of Goods Act 1979) where appropriate.

THE CURRENT LAW AND RECENT CHANGES

13.4 As discussed in Chapter 2,[1] there are separate rules for the transfer of ownership depending on whether the goods are specific goods, on the one hand, or unascertained or future goods, on the other. The Consumer Rights Act 2015 makes certain changes to the law on consumer sales of goods, but the provisions on transfer of ownership were not changed. For these, the 2015 Act refers back to the passing of property rules in the Sale of Goods Act 1979.[2]

13.5 Section 17 of the 1979 Act provides a general rule that property is transferred to the buyer when the parties to the contract intend it to be transferred. However, unless a different intention appears, section 18 of the Act sets out rules for ascertaining the intention of the parties.

[1] See para 2.88 and following.

[2] Consumer Rights Act 2015, s 4(2), which refers back to the Sale of Goods Act 1979, ss 16 to 20.

13.6 The rules on passing of property in the 1979 Act were developed for commercial contracts. As suggested in Chapter 2 and discussed in more detail in this chapter, the rules may cause confusion and operate harshly against consumers in an insolvency situation. We favour simple rules which can be applied in practice by administrators and shop staff, and which allow consumers to receive goods which have been identified for them and paid for.

13.7 We think that separate rules are needed for goods sold to consumers. In this chapter we propose two new rules about when ownership is transferred in a consumer sales contract:

(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 modify the goods in some way before the consumer takes possession.

(2) For unascertained or future goods, ownership should be transferred when goods are identified for fulfilment of the contract.

13.8 We ask whether these rules should be mandatory (so that they apply to all consumer contracts), or whether it should be possible to make alternative provision by agreement.

The transfer of ownership and the passing of risk

13.9 It is worth noting at this stage that the transfer of ownership of goods and the passing of risk in those goods are not necessarily contemporaneous in contracts for the sale of goods. In addition, there are different provisions about passing of risk when a retailer contracts with a consumer rather than a commercial purchaser.

13.10 Section 29 of the Consumer Rights Act 2015 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). Any damage to goods before delivery (including in transit to the consumer with a retailer-nominated courier) is therefore the responsibility of the retailer. Our proposals do not affect this.

13.11 However, we think the fact that separate rules about passing of risk apply in the context of consumer contracts is a useful model to support our arguments for separate consumer rules on transfer of ownership.

SPECIFIC GOODS

13.12 Where goods are identified and agreed upon at the time of the contract and are thus specific goods, property generally passes at the time the contract is made under Rule 1 of section 18 of the 1979 Act. This depends on the contract being unconditional and the goods being in a "deliverable state".[3] We do not propose to change the substance of the basic rule as it applies in the majority of cases – such as when goods are taken away immediately by the consumer or where, for example, a consumer purchases a particular display model "as seen" with delivery to follow at a later date.[4]

13.13 Rule 2 of section 18 provides that, where the seller is bound to do something to specific goods in order to put them into a deliverable state, property does not pass until that thing is done and the buyer has notice of the fact.

13.14 As discussed in Chapter 2, there is some doubt about when goods can be said to be in a "deliverable state" if the retailer has undertaken to modify or personalise the goods for the consumer in some way before the consumer takes possession.

13.15 The term "deliverable state" is defined in section 61(5) of the 1979 Act:

> 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.

13.16 The practical application of these rules, and this definition, is not entirely clear. Take 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? Because of the doubts surrounding the meaning of deliverable state, it is not clear whether rule 2 would apply in the context of our ring example. Is the purchaser "bound to take delivery" of the ring if it has not yet been inscribed? Is this inscription necessary in order to put the goods into a deliverable state?

13.17 Nearly all the case law we identified concerns commercial contracts, and much of it concerned the question of transfer of risk rather than the transfer of ownership. One case involved 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.[5] It is difficult to apply such cases to common scenarios in the consumer context, where the risk does not transfer until delivery.

[3] Sale of Goods Act 1979, s 18, rule 1.

[4] Rule 1 explicitly states that it is immaterial whether payment or delivery, or both, are postponed.

[5] *Underwood Ltd v Burgh Castle Brick & Cement Syndicate* [1922] 1 KB 343. In the consumer context, *Rohit Kulkarni v Manor Credit (Davenham) Ltd* [2010] EWCA Civ 69 discusses a number of these issues including deliverable state and when unascertained goods are unconditionally appropriated. It further demonstrates the difficulties which can arise.

13.18 In our ring example, whether or not the consumer is bound to take delivery of the ring before inscription is a matter of construction of the particular contract.[6] If the inscription is a condition of the contract of sale, then the contract is conditional on the inscription and property would not pass until the inscription is completed. This seems harsh in an insolvency situation where, without a property right, a consumer who had paid for a valuable ring would be left with an unsecured claim.

13.19 On the other hand, it might 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. This would mean that the consumer would be bound to take delivery of the ring before inscription, and therefore that property passed at the time of the contract of sale. The consumer could therefore claim the ring from the administrator, on paying the balance of the price.[7]

13.20 It is not desirable that the ownership of goods in this scenario should be so unclear. It is impractical to require administrators and shop staff to construe contracts in order to determine the position in each case. While the courts might try to construe the law in order to benefit a consumer in this case, in practice it is far more likely to be the administrator who is interpreting the rules. We think that under the current rules, administrators are likely to err on the side of caution and instruct shop staff not to release such property to prepaying consumers, even upon payment of any balance due. We think that in a consumer context the existing rules are unacceptably uncertain and should be reformed.

13.21 In their report *Consolidation and Simplification of UK Consumer Law*, commissioned by the Department for Business, Innovation and Skills, Professors Howell and Twigg-Flesner considered ways in which the rules relating to the transfer of ownership could be improved for consumers. In relation to the sale of specific goods to consumers, they recommended that rule 2 in section 18 of the Sale of Goods Act 1979 should be abolished and that the requirement in rule 1 that goods be in a "deliverable state" be done away with.[8]

Our proposal: specific goods

13.22 We propose 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 goods to the buyer's specifications).

[6] Benjamin, *Sale of Goods* (9th ed, November 2014) para 5-032 and fn 181 and 182.

[7] See discussion about payment below from para 13.41.

[8] G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) para 8.59 to 8.69. The authors also recommend that rules 3 and 4 in section 18 of the Sale of Goods Act 1979, which we do not consider here, be abolished.

13.23 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 but 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. The consumer would be liable for any unnecessary damage caused to the retailer's property.

UNASCERTAINED OR FUTURE GOODS

13.24 For unascertained and future goods, there is a presumption that ownership passes to the buyer when the goods 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.[9] This rule was developed for commercial contracts, and again the case law can be difficult to apply to retailer insolvency in the consumer context. The concept of "unconditional appropriation" is too obscure for administrators, shop assistants and consumers to apply in practice.

13.25 As we said in Chapter 2, there is a presumption that goods are unconditionally appropriated when the seller delivers the goods to the buyer or to a carrier. Setting aside and labelling goods for dispatch to the buyer is not necessarily sufficient.

13.26 In their report, Professors Howell and Twigg-Flesner proposed two options in relation to the rule on unascertained (or generic) goods:[10]

(1) Replacement of the criterion that goods be "unconditionally appropriated to the contract" with one that the goods become "identified to the contract"; or

(2) Immediate transfer of ownership of goods to the consumer, in the order in which the goods are purchased.

13.27 We consider each of these proposals in turn. We then explain why we favour a new rule for consumer contracts stating that ownership is transferred when goods are identified for fulfilment of the contract.

Identification

13.28 As we noted in Chapter 2, goods may be identified through setting them apart and labelling them without their necessarily being unconditionally appropriated to the contract.

[9] Sale of Goods Act 1979, s 18, rule 5. The assent may be express or implied.

[10] G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) para 8.70 to 8.83.

13.29 At the end of 2008, European contract law experts produced an academic Draft Common Frame of Reference (DCFR) which contained principles, definitions and model rules of contract law for the European Union based on a study of the position in different national legal systems and under existing EU law. The DCFR uses the concept of identification. It states:[11]

> Where the contract or other juridical act, court order or rule of law defines the goods in generic terms, ownership can pass only when the goods are identified to it.

Identification is therefore a pre-condition to the transfer of ownership under the model law. The accompanying commentary[12] explains that there are no set requirements for "identification"; rather it is a matter of proof. The notes confirm that the act of identification need not be irreversible or unconditional: if a transferor has separated and marked goods for the transferee, this is thought to be sufficient for identification. The fact that the transferor still has the *possibility* of changing their mind and returning the goods to the general stock would not defeat the act of identification (provided this has not in fact been done).

13.30 With the Scottish Law Commission, we issued advice to the UK Government concerning the optional Common European Sales Law (CESL) in November 2011. We argued that:[13]

> property in the goods should pass as soon as the goods are labelled. … Labelled goods still in the business's warehouse would be handed to the courier for onward delivery.

13.31 Professors Howell and Twigg-Flesner thought that the concept of identification would be less obscure than that of unconditional appropriation. It would also allow more goods to be passed to consumers, and would therefore "reduce the risk of consumers losing out in cases of trader insolvency".[14]

13.32 However, they also saw disadvantages to this approach. They offered two examples of situations where it could be problematic:[15]

(1) Where goods are to be manufactured by the retailer, they may be broadly identifiable from the moment the contract is made and the retailer starts to work on them.

[11] DCFR, VIII. 2:101(3). We have not at this stage considered the rules relating to ownership in bulk which are also covered in the DCFR.

[12] C von Bar, E Clive and H Schulte-Nölke (eds), *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference* (October 2009) p 4075.

[13] Law Commission and Scottish Law Commission, *An Optional Common European Sales Law: Advantages and Problems, Advice to the UK Government* (November 2011) para 4.44, http://lawcommission.justice.gov.uk/docs/Common_European_Sales_Law_Advice.pdf.

[14] G Howells and C Twigg-Flesner (eds) for Department for Business, Innovation and Skills, *Consolidation and Simplification of UK Consumer Law* (November 2010) para 8.74.

[15] Above, para 8.76.

(2) Alternatively, there may be no indication that goods are for a particular contract until the moment they are unconditionally appropriated to it.

13.33 They expressed concern that courts might interpret "identification" similarly to "unconditional appropriation". However, this could be remedied by statutory guidance on what would constitute "identification" in the context of consumer contracts.

Immediate transfer of ownership

13.34 The second approach advanced in the Howell and Twigg-Flesner report, and the one preferred by the authors, was that ownership of goods transfers immediately to consumers when they conclude a contract. If this were to happen, there would be no need for later identification or unconditional appropriation by the retailer. The authors explain how this would work in practice:

> 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 consumers), 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.

13.35 The authors thought this approach would avoid uncertainties based on the interpretation of "unconditional appropriation" or "identification". However, they also indicated potential problems inherent in this approach.[16] For example, where there are insufficient items in stock when a retailer becomes insolvent, there would be no goods for consumers "at the end of the queue" who have not yet received ownership of goods. Such an approach would result in a large proportion of the retailer's stock belonging to consumers – both goods that have been labelled for consumers and those that have not. This could, of course, greatly diminish the assets available to other creditors and reduce the security of banks and other lenders. Finally, the rule may also be difficult for staff to apply in practice.

13.36 Further, in the case of a still solvent retailer, such an immediate transfer of ownership may create difficulties where a consumer does not pay for the goods or later changes their mind. It would also limit a retailer's ability to fulfil the order with another identical product (for example, an identical piece of furniture located in a warehouse closer to the customer).

[16] Above, para 8.81.

Our proposal: unascertained and future goods

13.37 We favour a simple rule which can be applied in practice by administrators and shop staff and which allows consumers to receive goods which are both identified and paid for. However, we do not agree that ownership should pass immediately. As discussed, this would significantly reduce the amount of assets available to other creditors. Furthermore, the process of fulfilling orders relating to all stock could be very laborious and might reduce the possibility of selling the business to new buyers.

13.38 We think that ownership of the goods should be transferred to the buyer where goods have been identified for the fulfilment of that contract. Such identification may include labelling the goods or segregating them from the retailer's general stock.

When are goods identified for the fulfilment of the contract?

13.39 It may be helpful to set out in more detail how we see this rule working. Goods have clearly been identified when they are labelled with the customer's name or order number, though this would not be necessary in all cases. They may also be identified when they are set aside to await collection, or altered to the customer's specification (for example, where curtains are shortened).

13.40 Goods would also be identified to the contract when they are unique. For example, if only one customer ordered a red polka sofa and one such sofa was delivered, 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 be transferred until the sofa was labelled or set aside. However, this may still allow for earlier transfer of ownership than the current requirement for the goods to be "appropriated to the contract". Such identification need not be irreversible, but it will be a question of fact and proof whether the goods are identified at the point when the administrators are appointed.

PAYMENT

13.41 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.

13.42 On balance, we would favour retaining this approach in the new consumer rules. However, the buyer's right to obtain possession of the goods depends on the buyer having paid for them in full. Where a consumer has not fully paid for the relevant goods, the retailer or administrator would 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.[17] This means that the seller has a right to retain the goods until the whole of the price has been paid, even if the buyer has already become the owner of the property.

[17] Sale of Goods Act 1979, s 39(1).

SHOULD THESE RULES BE MANDATORY?

13.43 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 is appears that the parties intended property to pass at an earlier or later point in time. However, in a consumer context, rules such as that governing the transfer of risk in the Consumer Rights Act 2015 are mandatory. We therefore ask consultees whether the new rules we set out should apply in all cases, or if they should be subject to the contrary intention of the parties.

13.44 In practice, we do not think that either consumers or retailers would be in a position to turn their minds to such a technical issue. Our initial thought is that it would be simpler to provide mandatory rules to apply in all cases.

IMPACT OF THESE PROPOSALS

13.45 Where the retailer is trading in administration, the rules would be relatively easy to apply. For specific goods, staff could be directed to hand over specific goods which are being held by the retailer awaiting alteration (or where the alteration has been completed and the goods are merely awaiting delivery).

13.46 For unascertained or future goods, staff could be directed to hand over those goods which have already been labelled. Consumers are generally not in a position to enter a retailer’s warehouse and see for themselves whether a label with their name has been attached to goods. However, where the parties are acting in good faith such a change in the law might provide greater consistency in how administrators deal with pending orders and increase the chances they will be released to consumers.

13.47 Where there is no trading in administration, consumers would be required to visit the retailer or other holding location at their own expense to reclaim goods, in the same way as suppliers with retention of title clauses.

13.48 We accept that these new rules would have a relatively 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 think they would reduce the number of disputes and be perceived as less obviously unfair to consumers. We do not think they would significantly reduce returns to other creditors.

STATUTORY REFORM

13.49 These proposals would require statutory reform. Although the relevant provisions are currently contained in the Sale of Goods Act 1979 (to which the Consumer Rights Act 2015 refers back), we think that consumer-specific provisions would be better made as amendments to the 2015 Act itself.

PROPOSALS AND QUESTIONS

Proposal 9 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.

Proposal 10 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.

Q22 Do consultees agree with these proposals? In particular:

(1) Would they assist administrators in determining whether to fulfil consumer orders?

(2) What impact would they have on other creditors?

Q23 Should these rules be mandatory, so that they apply by law to all contracts? Alternatively, should the parties be able to agree alternative provisions?

Q24 Are there any arguments for ownership of goods to be transferred immediately to consumers upon conclusion of the contract?

CHAPTER 14
LIST OF PROPOSALS AND QUESTIONS

This chapter brings together all of the provisional proposals and consultation questions contained in this consultation paper. We invite consultees to comment on all or some of these, as appropriate. This will greatly assist us in formulating our recommendations for reform.

CHAPTER 8: ASSESSMENT

Q1 Do consultees agree that the protection given to some types of consumer prepayments on retailer insolvency should be reformed?

Q2 In this report we identify two particular sectors where consumers risk losses on retailer insolvency: gift vouchers and deposits in the furniture and home improvement sectors. Are there other sectors in which consumer prepayments are particularly problematic in the event of retailer insolvency?

CHAPTER 9: CHARGEBACK

Proposal 1 [para 9.11] 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.

Proposal 2 [para 9.14] All card issuers should give consumers a brief explanation of how to raise a chargeback. This should include:

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

(2) 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;

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

Proposal 3 [para 9.16] Card schemes should provide a publicly available authoritative guide on how chargeback works.

Q3 Do you agree with these proposals?

Q4 If so, do you have any comments on how they should be implemented?

Q5 [para 9.18] Our provisional view is that chargeback should not be required by legislation. We seek views for and against legislating for new legal duties to be imposed on card issuers to refund payments in circumstances currently covered by chargeback.

CHAPTER 10: POSSIBLE MEANS OF PROTECTION

Q6 [para 10.7] Would trusts designed to protect some rather than all prepayments (either where funds could be drawn-down, or where only some prepayments were put into trust), be an acceptable compromise in situations where ring-fencing all prepayments is not practical or affordable for the business?

Q7 [para 10.14] Would it be useful to develop a series of standard trust deeds which businesses could use to protect consumer prepayments?

Q8 [para 10.16] Do consultees have any experience of prepayment insurance? If so, we would be interested to learn more about:

(1) Cost of insurance and who bears this;

(2) Extent of insurance coverage and any limitations or exclusions which may apply;

(3) Claims procedure for consumers including documentation to be supplied;

(4) Interaction between insurance and section 75 claims (for example, whether consumers must first pursue a section 75 claim where available before making a claim under the insurance policy).

If applicable, we would also be grateful for sample policy documents.

Q9 What can be done to overcome barriers to consumer prepayment insurance?

Q10 [para 10.24] Is there merit in developing a new statutory "consumer charge" to be registered at Companies House, which businesses could use on a voluntary basis to give priority to some specified classes of consumer claims?

CHAPTER 11: A NEED FOR REGULATION?

Proposal 4 [para 11.16] Rather than introducing mandatory prepayment protection for all gift vouchers, retailers should be encouraged to take more voluntary steps to protect consumers.

Q11 Do consultees agree?

Proposal 5 [para 11.21] Providers of vouchers should state in the terms and conditions of the voucher whether or not the value of the voucher is subject to any protection in the event of insolvency.

Q12 Do consultees agree? Could this be introduced voluntarily, or would it require regulation?

Proposal 6 [para 11.25] It should be unlawful to market a scheme in a way which suggests that it can be used as a savings vehicle without putting some form of protection in place to protect the funds.

Q13 Do consultees agree?

We welcome additional comments on this proposal. In particular:

(1) Is our definition correctly targeted?

(2) What additional costs would our proposal impose?

Proposal 7 [para 11.37] Legislation should 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 alternative protection.

Q14 Do consultees agree?

Q15 What would the risks and potential costs be for any voucher intermediary (whether "high-risk" or not) if they were required to introduce protection mechanisms such as trusts, insurance or bonding?

Q16 Do consultees agree that sector-specific regulation is not a suitable means of protecting consumer prepayments in the furniture and home improvement sectors?

CHAPTER 12: LIMITED PREFERENTIAL STATUS FOR CONSUMERS

Proposal 8 [para 12.11] A limited category of consumer claims should be given preferential status, to rank behind employees but in front of floating charge holders. It would apply where the consumer provided a significant sum of new money to the business in the run-up to the insolvency, using a payment method which did not offer a chargeback remedy.

Q17 Do consultees agree with the policy behind this proposal?

Q18 Do consultees agree that the preferential status should apply to money paid within a set period before the date of entering administration/liquidation? We seek views on whether that set period should be three months.

Q19 Do consultees agree that preferential status should be limited to claims where the consumer has paid more than a certain amount, either in a single transaction or in a series of linked transactions? We seek views on whether that amount should be £100.

Q20 We seek views on the impact of this proposal generally. We are also interested in the following issues:

(1) Are retailers able to keep records of prepayments of (say) £100 or more made by cash or cheque, so as to present a running total of such sums to their floating charge holders?

(2) Would floating charge holders be able to monitor these sums?

(3) Do many businesses rely on these prepayments to a significant degree?

Q21 We are interested in hearing about examples of businesses:

(1) which rely on these prepayments but do not have secured creditors; and/or

(2) which successfully traded their way out of financial difficulties by relying on consumer deposits by cash or cheque.

CHAPTER 13: TRANSFER OF OWNERSHIP

Proposal 9 [para 13.22] 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.

Proposal 10 [para 13.37] 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.

Q22 Do consultees agree with these proposals? In particular:

(1) Would they assist administrators in determining whether to fulfil consumer orders?

(2) What impact would they have on other creditors?

Q23 Should these rules be mandatory, so that they apply by law to all contracts? Alternatively, should the parties be able to agree alternative provisions?

Q24 Are there any arguments for ownership of goods to be transferred immediately to consumers upon conclusion of the contract?

APPENDIX A
PEOPLE AND ORGANISATIONS WE HAVE TALKED TO

A.1 Between September 2014 and June 2015, the Law Commission met or otherwise corresponded with the following people and organisations with respect to the consumer prepayments project. We are extremely grateful for their time and for the information they have provided.

ABTA

Acorne

Barclays

Booksellers' Association

British Banking Association (BBA)

British Retail Consortium (BRC)

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

Financial Ombudsman Service (FOS)

Furniture Ombudsman

Green Deal Guarantee Company

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
§ 74 OF THE DANISH PAYMENT SERVICE AND ELECTRONIC MONEY ACT 2011

B.1 § 74 of the Danish Payment Service and Electronic Money Act 2011 reads as follows.[1]

(1) For payment transactions in connection with agreements regarding purchases of goods or services through distance sales initiated using a payment instrument [such as debit card], the payer's provider shall... omit to execute a payment transaction or, if it has been debited, immediately credit the payer's account, if the payer applies one of the following objections:

1) that the amount debited is greater than the amount agreed with the payee,

2) that the goods or services ordered have not been delivered, or

3) that the payer or one of the designated recipients has exercised an agreed or statutory right to annul an agreement by omitting to receive or collect the goods or service ordered.

(2) Prior to an objection in accordance with subsection (1), the payer shall have unsuccessfully contacted the payee with a demand for refund of the amount outstanding or delivery of the outstanding goods or services.

(3) If a payer has made an objection in accordance with subsection (1), the provider may only debit or redebit the payer's account, if the provider can confirm that the objection is unjustified.

[1] We are grateful to the Danish FSA for supplying us with an (unofficial) English version of this text. The translation can be accessed at https://www.finanstilsynet.dk/~/media/Regler-og-praksis/2012/C_Act365_2011_new.ashx.

APPENDIX C
CONSUMER CODES

C.1 This appendix contains provisions relating to protection of prepayments in consumer codes approved by Chartered Trading Standards Institute (CTSI) under its Consumer Codes Approval Scheme:[1]

Code Sponsor	Prepayment Protection
Bosch Car Service	BCS garages will: • In the event of a prepayment or deposit being made, **provide a clear receipt** which details the value of the payment made and the exact nature of the product and/or services that this payment relates to. • **Confirm to the customer how such a deposit or prepayment is protected** by Bosch in the unlikely event that the BCS garage ceases to trade.
British Association of Removers	Where agreed services cannot be delivered because of company failure (e.g. liquidation or bankruptcy) BAR will endeavour to **obtain the services of another BAR Member** to complete the contract. In the event that arrangements above are not feasible and pre-payments have been made which cannot be refunded by the Member because of company failure, the Customer may apply **for recompense from the BAR Pre-Payment Protection Scheme**.
British Healthcare Trades Association	Where refundable deposits/advance payments are taken**, a protection mechanism such as placing these in a separate account**, must be in place to ensure that consumers are returned their money without undue delay.
Checkmate	The Code is a mandatory set of requirements to ensure best practice before, during and after the purchase of a Home. **The Code applies to all homes with a Checkmate Warranty** that has an effective date after 30 April 2014. All Builders who provide a Checkmate Warranty agree to comply with the Code. **Checkmate Warranty**: an insurance-backed warranty providing the Buyer with cover for loss of Contract Exchange deposits and damage caused by defects as set out in the policy documents. The Builder must ensure that that Buyer is aware of the deposit protection covered under the Checkmate Warranty and section 10 of the Code.
Debt Managers Standards Association (DEMSA)	All clients' money must be held in **separate, ring fenced bank accounts** that are not available for use by the member for the purposes of its own business.

[1] This table is up-to-date as of May 2015.

	Members must demonstrate, by **annual audit certificates from a chartered accountant**, that client monies are held in a separate “ring fenced” bank account that would not be at risk in the event of a member ceasing to trade, and is not usable by the member for the purposes of its own business.
Institute of Professional Willwriters	Members who accept any payment made in advance shall **be required to take part in a prepayment protection scheme** to the satisfaction of the Sponsor. Members shall provide the Sponsor **with proof that they have arrangements in place to protect** and refund funds held on behalf of a client in the event of misuse or **business failure.**
Motor Codes (new cars)	We would advise you to be aware of who any deposit is being paid to and its security, along with the cancellation terms.
Motor Codes (service and repair)	We will not require deposits or prepayments for service and repair work.
Motor Codes (vehicle warranty products)	No provision.
The Carpet Foundation	The Carpet Foundation has developed a scheme to protect deposits (of **up to 50% of the order value**) to enable it to complete a carpet installation if the retailers business fails. **The Scheme does not make a monetary recompense but relies on the consumer contributing the deposit balance** of the originally quoted order. The Carpet Foundation, with the help of its suppliers and using this balance, will fulfil the order as originally quoted. For this reason **deposits greater than 50% cannot be protected.** Additional protection of deposits affected by liquidations is afforded by using a credit card to pay the deposit subject to a minimum total purchase price of £100.01 and it is recommended that this method of payment is used.
The Property Ombudsman (Residential Letting Agents)	You must at all times keep clients’ money in **a separate designated clients account** held in a financial institution appropriately authorised under the Financial Services and Markets Act 2000 and where relevant comply with your regulatory bodies’ rules or byelaws in relation to the handling of clients’ money. The **client should be advised** that monies will be held in a designated client account.
The Property Ombudsman (Sales – Residential Estate Agents)	**In England, Wales and Northern Ireland** **You should not take pre-contract deposits. However,** in the case of new home sales, you may take into account specific instructions from sellers. If a deposit is taken, then a written receipt must be given, and the circumstances under which the deposit is held and any interest accrued are refundable, must be clearly stated in writing.

	You must not hold a deposit, or any other money belonging to a seller or buyer client, unless you are covered by adequate insurance. Any client money held must by law be in a separate client account or accounts, as set out in the Estate Agents (Accounts) Regulations 1981. **You must be able to account immediately for all money you are holding on behalf of a client.** By law you must not deduct any cost or charges from any client's money you hold, unless your client has given you written authority to do so. You should ensure that your client's authority is obtained at the time of the deduction or that you give your client sufficient notice prior to the deduction to object to it. **In Scotland** Estate Agents or anyone engaging in estate agency work cannot accept pre-contract deposits.
Renewable Energy Consumer Code (RECC)	Code members will set out clearly in the contract the amount and timing of all payments required. If a Code member requires the consumer to pay a deposit when the contract is signed, this will constitute **a reasonable percentage of the estimated overall costs** of the work as set out in the contract, for example 15 per cent. **It should not exceed 25 per cent under any circumstances. Code members may only use this money for work under the contract,** for example for purchasing goods. Code members will repay the deposit within 14 days if the contract is cancelled in line with the conditions set out in the Code. **This is a very important requirement of the Code.** If the Code member subsequently requires a further advance payment to be made by the consumer, this must constitute a reasonable percentage of the overall costs of the work and will only be used for work under the contract, for example for purchasing goods. **Under no circumstances can the deposit and the further advance payment, taken together, exceed 60 per cent of the estimated overall costs of the work. Code members can only require a further advance payment no more than three weeks before the agreed delivery date of all the goods to be installed.** Code members must protect any deposit and any further advance payment, such that, if they should cease to trade or become insolvent before the contract has been completed, **the consumer will be able to have his or her contract completed at no additional cost by another Code member.** Code members may place such funds in a 'client' or other third party account or use the protected payment scheme which the Code administrator has arranged. The Code administrator has prepared guidance on third party accounts. Such funds must be separate from those accounts linked to the Code member's own credit and banking facilities and should only be used with the consumer's consent. (This can be obtained in advance when the consumer signs the contract.) **Code members must arrange to insure *all* deposits and advance payments.** The Code administrator has arranged a scheme with Quality Assured National Warranties (QANW) which Code members may use.

	It is part of the Deposit and Workmanship Warranty Insurance (DAWWI) Scheme. Code members may not require consumers to put in place their own insurance. Code members who take deposits and advance payments, and who cannot demonstrate that they have equivalent cover in place with an alternative insurance provider must take part in the Scheme. Code members must inform the Code administrator and consumers accurately about the arrangements they have in place to comply with this section of the Code. **Where a Code member uses a consumer's money, paid in advance, to purchase goods, and where those goods are delivered to the Code member, the Code member will hold the goods on trust for the consumer and will keep them separate from its own goods and those of third parties.** The Code member will keep such goods properly stored, protected, insured and identified as the consumer's property. The consumer should be able to inspect or repossess the goods at any time. The legal title to those goods, or the proportion of them that has already been paid for, should pass directly to the consumer. In this way, if the Code member becomes insolvent or ceases to trade (see glossary for definitions), before the installation takes place, the goods will remain the consumer's property.
VBRA (Vehicle Builders and Repairers Association)	(Repairers' code). If any pre-payment or deposit is required, **the business will have a procedure in place for the handling and security of such monies to ensure, in the event of non-supply of services or goods, the pre-paid money is safeguarded and can be returned.** The details of this procedure should be available on request from the member.

APPENDIX D
PREPAYMENT PROTECTION IN THE TRAVEL INDUSTRY

D.1 Prepayment protection for consumers in the travel industry is complicated and unclear. Protection applies principally to "package holidays", although some other kinds of travel arrangements may also be protected. In the United Kingdom, the safeguarding mechanisms for consumer prepayments, the body overseeing protection of consumer funds and the applicable statutory framework, will depend mainly on the means of transport booked.

D.2 The risk of consumer detriment in the travel sector is particularly high due to the presence of both risk factors identified in Chapter 6: the value of prepayments is significant; and the time between payment and delivery of the service often exceeds several months. Consumers may lose money if a tour operator becomes insolvent before departure, or may even find themselves stranded abroad if this happens during the holiday.

D.3 Consumers may make all kinds of travel arrangements. Traditionally, consumers would book a "package holiday", organised by a tour operator, through a travel agent. Such packages usually have flights, accommodation and possibly other services included in the price. However, the market has significantly changed. The internet now allows consumers to book packages online, and holidaymakers increasingly organise their own flights, accommodation or car hire and put together "packages" themselves. While this has brought prices down, it has upset the traditional protections which mainly reflect a pre-digital era.

D.4 In the 1960s, industry trade associations in the United Kingdom started to address the problems and the introduction of the Air Travel Organisers' Licence (ATOL) through the Civil Aviation Act 1971 brought further protection.

D.5 At the European level, the European Package Travel Directive published in 1990 required Member States to ensure prepayments for package holidays are adequately protected.

THE LEGISLATIVE FRAMEWORK

The Package Travel Directive

D.6 In 1990, the European Package Travel Directive ("the directive") mandated Member States to implement national protective measures for consumer holidaymakers who had booked and paid partly or in full for a pre-arranged package holiday (irrespective of the mode of transport). Protections include provision of adequate information prior to the conclusion of the contract and appropriate safeguarding of consumer funds to ensure a refund or repatriation of travellers on retailer insolvency.

Insolvency protection

D.7 Article 7 of the directive and regulation 16 of the Package Travel, Package Holidays and Package Tours Regulations 1992 (PTR) states that the organiser or retailer shall:

> provide sufficient evidence of security for the refund of money paid over and for the repatriation of the consumer in the event of insolvency.

D.8 Most Member States have a uniform system for the protection of consumer prepayments for package holidays which does not depend on the mode of transport.[1] However, as the United Kingdom already had protections in place which predated the directive, the Government decided to maintain the pre-existing distinction between air and non-air travel when it transposed the directive through the PTR. This has resulted in two concurrent schemes of protection dependent on the mode of transport employed:

(1) While subject to the PTR, package holidays involving air travel are exempt from its financial safeguarding requirements as they are already protected under the Civil Aviation Authority's ATOL scheme, overseen by the Department for Transport.

(2) Travel organisers providing packages involving other types of transport must safeguard funds in one of the three mechanisms laid out in regulations 17 – 21 of the PTR.

Revision

D.9 The Package Travel Directive is currently being revised at European level. It is expected that the new directive will be published later this year and be implemented in the United Kingdom by 2017/2018. As at 5 June 2015, the European Council and Parliament had reached political agreement on the text of the revised directive. The provisions on package organiser insolvency, set out in articles 15 and 16 of the agreed text, are significantly more elaborate than those in article 7 of the current Package Travel Directive. A risk-based approach appears to have been adopted:[2]

> The security shall be effective and shall cover reasonably foreseeable events costs. It shall cover the amounts of payments made on behalf of travellers in respect of packages, taking into account the length of the period between down payments and final payments and the completion of the packages, as well as the estimated cost for repatriations in the event of the organiser's insolvency.

[1] Germany, for example, requires companies providing package travel to have insurance from one of four insurance companies whereas Denmark operates a Travel Guarantee Fund for such holidays.

[2] The document 8969/2015 is available on the website of the European Council under institutional file 2013/0246 (COD). See article 15(2).

The Package Travel Regulations 1992

D.10 The directive was implemented in the United Kingdom by the Package Travel, Package Holidays and Package Tours Regulations 1992 ("the Package Travel Regulations", the PTR). The PTR apply to "packages sold or offered for sale in the territory of the United Kingdom",[3] though packages subject to the ATOL Regulations are exempt from the financial protection requirements of the PTR.[4]

D.11 While the directive is silent as to how insolvency protection must be achieved, regulations 17 – 21 of the Regulations set out the mechanisms by which this may be done in the United Kingdom for non-ATOL protected packages: through bonding with an approved body, insurance or trust accounts. Regulation 16 makes it an offence to fail to implement financial protection in one of these ways.

Bonding with an approved body

D.12 Bonding is only possible under the PTR if the organiser is a member of an "approved body", defined in regulations 17 and 18 as a body approved by the Secretary of State for the purposes of the regulations. Examples of such bodies are ABTA and the Confederation of Passenger Transport (CPT), though others exist.

D.13 A bond is a guarantee given by a third party guarantor (normally a bank or other institution in the bond surety or financial insurance markets) to fulfil an obligation if the party who intends to fulfil it is unable to do so. If a bonded organiser in the travel sector becomes insolvent and is unable to honour consumer prepayments, the guarantor will provide funds to the value of the bond to the approved body of which the organiser is a member. The organiser will pay an annual premium in exchange for the guarantor's commitment to pay out on the bond should it become insolvent.

D.14 Regulation 17 requires the organiser to obtain a bond that will be paid in the event of its insolvency to an approved body of which it is a member. The value of the bond must be reasonably expected to enable all monies paid by consumers under contracts for packages which have not been fully performed to be repaid. At a minimum, the value of the bond must not be less than the smaller of:

(1) the maximum amount of all the payments which the organiser expects to hold at any one time in respect of contracts which have not been fully performed; or

(2) 25% of all the payments which the organiser estimates he will receive under or in contemplation of contracts for packages in the 12 month period following the entry into force of the bond.

[3] Package Travel Regulations 1992, reg 3(1).

[4] Package Travel Regulations, reg 16(2)(b).

D.15 Where the approved body of which the organiser is a member has a reserve fund or insurance, regulation 18 reduces the minimum bond value to 10% (rather than 25%) of all the payments the organiser expects to receive for packages in the subsequent year.[5] The reserve fund or insurance cover must be sufficient to allow prepayments to be refunded to consumers if the package has not been performed and the member becomes insolvent.

Insurance

D.16 As an alternative to bonding, organisers may wish to insure consumer prepayments. Regulation 19 allows organisers to have an “appropriate policy” with an insurer that agrees to indemnify consumers (insured persons under the policy) against the loss of money paid by them in the event of a retailer’s insolvency. The organiser is to ensure that it is a term of every contract with a consumer that the consumer acquires the benefit of such a policy.

D.17 An “appropriate policy” is one which does not contain a condition excluding liability or causing liability to cease, including where the policy holder (that is, the organiser) has not made payments under the policy or which makes liability to be contingent on the policy holder keeping specified records or making information available to the insurer.

Trust arrangements

D.18 Should an organiser not wish to take out a bond or appropriate insurance cover, regulation 20 allows monies paid by consumers for package holidays to be held on trust for the consumer. Costs of administering the trust are to be borne by the organiser, though any interest which is earned on the monies subject to trust shall be held by the trustee for the retailer and payable to him on demand. The trustee will release consumer prepayments to the retailer when contracts have been fully performed, where funds have demonstrably been repaid to the organiser, or where the consumer has cancelled the package and forfeited payment.

D.19 On insolvency, monies held in trust by trustee shall be applied to meet the claims of consumers in respect of the holiday packages they purchased but which were not performed as a result of the organiser’s insolvency. Two exceptions to the general distribution principles of trusts law are made: if there are insufficient funds to meet the claims of consumers, payments shall be made on a proportionate basis; conversely, any surplus of funds after repayment to consumers will revert to the organiser’s estate and be available to the general body of creditors.

D.20 If an organiser makes a false statement to the trustee to enable release of funds, or uses monies released by the trustee for any purpose other than that for which it is intended, this will constitute an offence under regulation 22 of the PTR.

Sanctions and enforcement

D.21 Regulation 16 (safeguarding of funds) and regulation 22 (offences relating to the trust) are enforced by local authority Trading Standards officers.

[5] Or the maximum amount of payments held at any one time, if this is lower.

D.22 We will consider the current position with respect to package holidays, before looking at travel arrangements which do not qualify as packages and other means of redress available to consumers.

PACKAGES INVOLVING FLIGHTS

The ATOL Regulations

D.23 The original ATOL Regulations were issued in 1972 under the Civil Aviation Act 1971 and the current version of the ATOL Regulations date from 2012.[6] They require organisers who provide air travel or packages involving air travel in the United Kingdom to hold an ATOL licence, but they do not apply to sales made by airlines, whether directly or through agents.[7] Licensing allows the Civil Aviation Authority (CAA), which administers the ATOL scheme, to determine a company's degree of risk and ensure adequate financial protection mechanisms are in place.

D.24 The scheme predates the Package Travel Directive and flight-based packages subject to ATOL are therefore exempt from the financial protection requirements of the UK Package Travel Regulations. They are governed instead by the Civil Aviation (Air Travel Organiser's Licensing) Regulations 2012 ("the ATOL Regulations").

D.25 The Department for Transport oversees the ATOL scheme. In a recent Call for Evidence, it noted that between 2009 and 2013 over 100,000 people were repatriated under the ATOL scheme at a cost of £40 million, while nearly 500,000 received refunds totalling £130 million.[8]

D.26 Since 2012, ATOL protection has extended beyond traditional packages involving a flight and accommodation booked as one deal. It now covers "flight-plus" arrangements, where consumers may believe they are booking a package by purchasing a flight and either accommodation or car rental within a day of each other from the same organiser. Scheduled airline flights remain outside the scope of the ATOL scheme,[9] though flights on their own sold by a non-airline may be covered in some circumstances.

Financial protection under ATOL

D.27 The CAA requires an initial £50,000 bond from ATOL licencees.[10] However, this requirement will be lifted once a business is established and there is no continued bonding requirement. The CAA may require additional measures such as refinancing, bonds or escrow arrangements from financially troubled businesses, as a condition of their continuing to trade.

[6] The Civil Aviation (Air Travel Organisers' Licensing) Regulations 2012

[7] ATOL Regulations 2012, reg 9.

[8] Department for Transport, *Review of Package Travel Directive and ATOL Implementation and Funding Arrangements: Call for Evidence* (May 2013) p 22.

[9] When the original ATOL Regulations were introduced, most airlines were state-owned and the probability of their insolvency was thought to be low: ATOL 2011 consultation, p13.

[10] Increased from £40,000. See http://www.caa.co.uk/application.aspx?catid=14&pagetype=65&appid=7&mode=detail&nid=2434.

D.28 The scheme is financed by a levy of £2.50 per passenger travelling (ATOL Protection Contribution, APC), which is paid into the Air Travel Trust (ATT) fund. The APC was introduced in 2008 – originally at a cost of £1 – is a flat fee. The levy is paid by the ATOL holder who will usually include the cost in the advertised price paid by the consumer. At March 2014, ATT had a balance of almost £55 million, though it also has a £300 million insurance policy as well as a £75 million overdraft facility.[11]

D.29 The Department for Transport's 2013 Call for Evidence noted that four failures in the last decade had alone cost a total of £130 million: £57 million was financed by bonds required under the terms of the ATOL licences and the remaining £73 million was obtained from the ATT. These four failures accounted for 66% of total ATT expenditure of £111 million during the ten year period between 2003 and 2013.[12] Over the last 10 years ATOL has protected around £170 billion of revenue.

Reform of ATOL

D.30 Since 2010, the Department for Transport has been conducting a widespread review of the ATOL regime.[13] It has introduced protection for Flight-Plus arrangements as well as an ATOL certificate for consumers, which proves and details their coverage. In May 2013, it issued a call for evidence on the funding arrangements of the Package Travel Directive and ATOL implementation.[14] The Civil Aviation Act 2012 brings in new powers to make regulations in the future for flights and holidays sold by airlines and retailers acting as "agents for the consumer".[15]

PACKAGES NOT INVOLVING FLIGHTS

D.31 Where a package does not involve airline travel, ATOL protection will not apply. However, the organiser of the package will be subject to the financial protection requirements of the PTR. The consideration of a cruise as a package subject to financial protection varies between EU Member States, though it has always been treated as one in the United Kingdom. While there was previously a separate organisation for cruises (the Passenger Shipping Association), ABTA now covers most of this sector.

[11] Civil Aviation Authority, *Air Travel Trust Annual Report & Accounts* (March 2014) p 11.

[12] Department for Transport, *Review of Package Travel Directive and ATOL Implementation and Funding Arrangements: Call for Evidence* (May 2013) p 24.

[13] https://www.gov.uk/government/consultations/atol-reform-consultation.

[14] Review of Package Travel Directive and ATOL Implementation

[15] Civil Aviation Act 2012, s 94 which amends s 71 of the Civil Aviation Act 1982.

D.32 It was noted above that the PTR allow consumers' payments for packages to be protected in three ways: bonding, insurance and trust arrangements. In the United Kingdom, the predominant way in which this obligation is fulfilled is through bonding and membership of ABTA, a trade association which is also an approved body for the purposes of regulation 18. As ABTA is the main approved body in the United Kingdom, we will focus on it here. There are, however, other approved bodies such as the Confederation for Passenger Transport, a trade association for small coach operators which runs the Bonded Coach Holiday Scheme.

D.33 Bonding is the only financial protection mechanism of the three that requires membership of an approved body. There is no requirement to be part of a trade association such as ABTA or an approved body if an organiser chooses to protect prepayments with insurance or trust arrangements. However, while an approved body can ensure its members have bond coverage in place, ensuring insurance and trust arrangements are sufficiently robust can be problematic.

ABTA

D.34 ABTA is a trade association which was established in 1950. Its bonding scheme caters mainly to organisers who offer non-air holidays such as cruise packages, coach and train holidays, overland arrangements, golf breaks and spa packages. ABTA generates income from membership fees.

D.35 Although widely associated with financial protection, ABTA's role as a trade association is wider. It represents the interests of member travel agents and tour operators and operates a code of conduct with a disciplinary committee and independent complaints resolution service to deal with any disputes between consumers and members, with an independently operated arbitration scheme. Organisers who are already subject to the financial protection requirements of the ATOL scheme may thus also be members and ABTA runs the ABTA-ATOL Joint Administration Scheme (JAS), whereby the CAA grants the ATOL licence and ABTA administers the application on behalf of the member.

D.36 ABTA requires its members offering products which require protection under the PTR to provide evidence of their liability insurance arrangements each year, in addition to their financial protection arrangements for prepayments. Businesses entirely protected by ATOL and those offering non-package holidays are not obliged to offer safeguards, though ABTA extends its scheme through various voluntary financial protection arrangements, allowing members to gain a commercial or marketing advantage (for example, for accommodation-only sales).[16] ABTA requires members to publish various statements depending on the level of protection offered.

[16] Initially, ABTA had also insisted on protection of accommodation-only bookings. However, as these do not have to be protected under the PTR, its members found themselves at a disadvantage to non-ABTA members. ABTA subsequently dropped this requirement, which resulted in it leaving the OFT Consumer Code Approval Scheme.

D.37 Of the three methods of protection (bonding, insurance, trust) permitted by the PTR, ABTA requires its members to have either bonding or insurance in place. Bonding is chosen by the majority of members, with 6 to 8% of members opting for insurance. It does not allow trust arrangements as it considers that no checks are in place to ensure retailers are implementing them correctly at all times, and due to the difficulties in managing the failure of a travel organiser when monies are held in trust.

Principals and agents

D.38 ABTA differentiates between principal and agent members. It has 800 principals, 680 which are also ATOL holders, and 800 agents. There is some overlap between these two categories as 400 in each act as "dual members", variously conducting business as both principal and agent. In total, there are 1200 members.

D.39 Agents do not need to be an ABTA member nor provide financial protection for consumers under ABTA if the principal for which they are selling has protection. However, if they are selling packages as an agent for suppliers which are not a member of ABTA, they must also ensure financial protection is in place.

Bonding with ABTA

D.40 ABTA requires its members who organise package holidays to have financial protection in place. It operates an insurance fund, which brings the minimum bond members must hold to 10% of annual turnover, rather than 25% (which would be the case were no reserve fund or insurance arrangement in place). The existence of an insurance fund protects against any shortfall if the bond is insufficient to refund prepayments.

Value of the bond

D.41 The PTR mandate a minimum bond value of 10% of a company's turnover where the approved body has insurance in place,[17] though in practice, ABTA will initially require a bond to a minimum value of 15% of turnover and at least £40,000 during the first three years. This will generally reduce to 10% over time. In some cases and depending on the risk profile, where there is a significant turnover, ABTA may continue to require a 15% or greater bond. The value of the bond for cruise holidays may also be higher at 30 to 40% of turnover due to the high value of prepayments and early booking date (the two risk factors identified in chapter 6). Discounts for paying in full at the time of booking are also be common in this sector.

D.42 ABTA's key consideration is the risk involved. For each member, ABTA determines the value of the bond in September or March, times of the year where organisers' financial worries might become apparent. While it might be unfeasible to require a bond equivalent to 100% of risk turnover, the seasonal nature of the travel industry makes it possible to identify peaks and troughs of risk.

[17] Or one which covers the total of payments held by an operator at any one time, if this amount is smaller.

D.43 To obtain a bond, the majority of members turn to a normal business bank, while others seek bonds in the surety market and a minority in insurance markets. The actual cost of the bond is defined by the market: strongest companies may pay 1% of the bond's value, but this could rise to 12% dependant on risk. Security will also be required.

D.44 If a company's entire business structure and the entirety of the products it sells are ATOL-protected, ABTA will not require a bond. Although an ATOL licensee will, in any case, be exempt from the PTR, ABTA may require a bond if the member sells unprotected products.

Captive insurance fund

D.45 ABTA operates a captive insurance company, ABTA Insurance PCC Ltd, as a back-up fund. Although all ABTA members are required to have a bond, recourse to the insurance fund may be necessary where the value of the bond is not sufficient.

D.46 The captive insurer is a wholly-owned subsidiary of ABTA, set up 22 years ago in Guernsey[18] to isolate the organisation from fluctuations of the external reinsurance market. As the captive insurance fund is not domiciled in the United Kingdom, it may not be covered by the (unlimited) Financial Services Compensation Scheme guarantee if it itself fails. ABTA argued that the fund, as a wholly-owned subsidiary of ABTA Ltd, is fully funded.

D.47 As well as paying for a bond (at an annual cost of 1 to 12% of 10 to 15% of turnover), members must also pay a risk-based premium into the captive fund. ABTA Ltd, the trade association, also pays a premium to ensure that it can always keep the ABTA promise and refund consumers. This is part of ABTA's reputational management but the organisation told us that it sometimes feels that it is "the last goalkeeper standing" when statutory or other schemes fail to respond.

ABTA's liability

D.48 ABTA typically sees approximately 20 to 30 failures per year, but the absolute number of failures is not as important as their scale. In the 22 years the captive insurance has been in place, ABTA has paid a total of £60 million in claims: half of this came from members' bonds and half from the captive insurance fund.

Bonding arrangements outside ABTA

D.49 One example of a bonding scheme outside ABTA is the Bonded Coach Holiday Scheme (BCH), run by the Confederation for Passenger Transport (CPT), a trade association for small coach operators.

D.50 As the PTR require an approved body to be the obligee of the bond, bonding is unlikely to be prevalent among operators which are not a member of an approved body. In any case, bonding without the involvement of an approved body would not fulfil the PTR requirements and be subject to a fine.

[18] Captive insurance funds are not permitted in the United Kingdom.

Insurance

D.51 As an alternative to bonding, ABTA also allows its members to take out insurance to guarantee consumer prepayments. However, it imposes the additional requirement that the policy must be taken out with an underwriter it has approved. This ensures that policies do not contain terms and conditions in conflict with the PTR, allowing ABTA to ensure that any policies will provide the level of financial protection mandated by legislation.

D.52 Only a minority of ABTA members opt for insurance instead of bonding (50 to 60 of 800 principals). The number is small because insurance is a more expensive option than bonding and, ABTA argues, not as well served or efficient as the bond market. However, the insurance market may be more accessible to weaker companies (at a premium) as well as to new entrants.

D.53 Unlike bonding, insurance does not require the involvement of an approved body. ABTA suggested that this makes it impossible to determine how many non-ABTA members are using insurance. A danger also exists that non-ABTA approved insurance policies are not suited to the requirements of the PTR or their underwriters are unwilling to pay when a business fails.

D.54 An example of an insurance policy seeking to avoid liability is provided by Skiing Europe, a non-ABTA member, which had financial insurance with Amtrust. When Skiing Europe failed, the underwriter alleged the policy holder had not fully disclosed the director's background and refused to pay out. The Association of Independent Tour Operators (AITO), of which Skiing Europe was a member, temporarily suspended its 100% financial guarantee finding that the policy was "not fit for purpose" as the insurer was able to cancel the policy due to the material non-disclosure. In a statement, AITO said:

> We believe that this is a very serious shortcoming in terms of the insolvency protection provided to consumers by the Package Travel Regulations.

D.55 The European Court of Justice confirmed that the guarantee provided by article 7 of the European Package Travel Directive is to be interpreted as covering a situation in which the insolvency of the travel organiser is attributable to its own fraudulent conduct.[19]

D.56 ABTA avoids potential detriment for consumers in situations where its approved insurers seek to avoid liability as it has entered into a collateral deed with the insurers.

Trust arrangements

D.57 Although permitted under the PTR, ABTA does not allow its members to safeguard funds through trust arrangements as it considers there is a lack of registration, governance, oversight and supervision from the Department for Business, Innovation and Skills or trading standards, and that the practical application of funds held in a trust can be difficult where an organiser fails.

[19] C-134/11; 16.02.2012.

D.58 Given the lack of registration, it has not been possible for us to determine how many organisers employ trust arrangements to fulfil their obligations under the PTR.

NON-PACKAGE TRAVEL ARRANGEMENTS

D.59 Financial protection is not required for travel arrangements which do not constitute a package in the sense of the Package Travel Regulations or require an ATOL licence. The obvious danger to consumers is the difficulty of determining whether their travel arrangements are considered a package.

D.60 However, unprotected products such as scheduled flights booked directly with the airline, accommodation and car rentals and unregulated packages (those sold by and booked directly with tour operators outside the EU) may be protected by chargeback. Additionally, some ABTA members may offer additional voluntary protection for products such as accommodation; and ATOL flight-plus protection also goes beyond the strict requirements of the Package Travel Directive by protecting sales which seem like a package but do not fall within the strict definition.

OTHER MEANS OF PROTECTION

D.61 Consumers may benefit from other financial protections when prepaying for travel arrangements. Depending on the nature of the arrangements, such additional protections may overlap with those described above.

Chargeback

D.62 We noted in Chapter 5 that chargeback is a powerful tool for consumers who have prepaid when a retailer becomes insolvent. Where a consumer has paid for travel arrangements by credit or debit card, chargeback protection will also apply irrespective of whether the travel arrangements are deemed a package. It thus both overlaps with ATOL and PTR protection, on the one hand, and also offers protection for arrangements falling outside the scope of ATOL and the PTR, on the other.

D.63 Where travel arrangements have been paid for in cash, by bank transfer or cheque, no chargeback protection will be available. However, a great many travel arrangements are now booked online with a debit or credit card. Unlike traditional travel agents, where a deposit may be taken and full payment required several months before departure, the risk involved for merchant acquirers may be even greater if full payment is made in advance online and the risk period is correspondingly longer.

D.64 Offering such protection to consumers brings with it its own difficulties: due to the long-tail nature of chargeback liability in the travel sector, merchant acquirers are likely to hold on to retailers' funds until the holiday is complete. ABTA thought that such retention of funds was sometimes justified as retailers have created a business model that involves taking prepayments far in advance and thereby created the risk. However, it questioned whether the system is as efficient as it could be: merchant acquirers may hold money back from travel organisers who also bear the cost of protection mandated by statute. A stark example of retention of funds in the travel sector is demonstrated by the failure of Flyglobespan, a low-cost airline. Its merchant acquirer, E-Clear, was reportedly holding on to significant funds at the time of the airline's collapse.

D.65 Although both debit and credit card claims will generally be treated through chargeback, consumers paying by credit card may also lodge a section 75 claim with their credit card company. This allows them to claim for any consequential loss such as the cost of repatriation.

D.66 As explained below, chargeback is, in fact, the primary source of redress for both protected and unprotected travel arrangements paid for by card. The integral role it plays even in a sector known for its financial protection clearly highlights the problems which could arise if it was withdrawn. However, even here, problems may arise. We were told that consumers may experience difficulty where both card and non-card payments are used; non-travelling cardholders (for example, parents) are involved; or business cards are utilised.

Package travel arrangements: overlap

D.67 Despite the protections in place where a consumer has prepaid for a package holiday, consumers may first be required to raise a chargeback (or section 75) claim with their bank.[20] If this is successful, the liability will be borne by the merchant acquirer. If the chargeback is not successful, ABTA will require a copy of the correspondence with the bank before honouring a claim. While this does prevent double-claiming by consumers (as they must first exhaust protection offered by their card), the situation also results in duplicated protection and does not represent a clear policy choice as to where loss should fall on retailer insolvency.[21]

[20] We were told that, for ATOL, the CAA has signed agreements with the business providing credit card payment-taking facilities to the travel industry, apportioning costs. ATOL pays all repatriation costs and all refunds arising from the sale the ATOL holder made through agents, because section 75 does not apply to such sales. For the remaining refund costs, ATOL pays all claims up to a notional threshold typically equal to 10% of the business' annual licensable turnover, and it is only if there is any excess over that the claimants are redirected to card issuers.

[21] Overlapping protection was considered by the Department for Transport in its *Review of Package Travel Directive and ATOL Implementation and Funding Arrangements: Call for evidence* (May 2013) pp 12 to 13.

D.68 The effect of this for organisers is that they pay for an ATOL or ABTA bond (or insurance) and receive delayed payment from merchant acquirers. Duplicate protection therefore increases costs which may be passed on to consumers. However, ABTA thought that the costs are not, in fact, that large for organisers with a well-controlled and strong balance sheet; though some members are very unhappy about it. In some cases, there are non-statutory ad hoc arrangements for ABTA or ATOL to use the organiser's bond first and then rely on the chargeback scheme.

D.69 There are some situations where chargeback protection is not co-extensive with industry protection, or vice versa:

(1) While repatriation is probably covered for credit card prepayments under section 75, it will not be covered by chargeback. Chargeback will therefore only be of use to the consumer for a refund; if they are stranded, ATOL or ABTA will have to step in.

(2) When Bookable Holidays failed, less than 100 of 900 air travel bookings ended up being protected through ATOL despite ABTA (and possibly consumers) believing full protection was in place. The remaining claims were refunded through chargeback or ABTA, where applicable.

D.70 Chargeback may also change where loss falls. In theory, ABTA and ATOL are responsible for meeting financial claims through the organiser's bonding arrangements and, if necessary, through their reserve funds. However, if the insolvent party is the travel agent with whom the consumer booked, loss will fall on the merchant acquirer instead; if the tour operator (or any principal) becomes insolvent, but the travel agent remains solvent, the latter will lose out.

Non-package travel arrangements

D.71 For unregulated travel arrangements (non-package and non-EU packages), chargeback will often be the only means of financial redress open to consumers, unless the arrangements are voluntarily protected. Of all the travel arrangements not covered by ATOL or the PTR, failure of scheduled airline companies is likely to affect the highest number of consumers. Card payments are extremely prevalent here as most flights are booked online, and chargeback protection should therefore be available to consumers.[22]

D.72 The drawback of chargeback is that it will only allow consumers to claim the amount they have paid by card, whereas section 75 credit card protection allows full recovery of prepayments where part has been paid by credit card. Unlike section 75, chargeback does not allow recovery of any losses resulting from the trader's insolvency. This may be particularly problematic where consumers build their own holidays. For example, where a consumer purchases a safari tour and books their own flights to get there:

[22] Airlines in countries, such as Germany, allow airline tickets to be bought by bank transfer (for example, Lufthansa). If this means of payment were to develop in this country, chargeback protection would be reduced.

(1) If the airline becomes insolvent, they will be able to chargeback the airfare. However, they will not be able to cancel the holiday and will have to organise alternative flights (at their own cost) to get there. Section 75 protection for credit cards should cover any additional costs for the new flights.

(2) If the safari tour operator becomes insolvent, they will be able to chargeback the amount of the holiday. However, they will not be able to cancel their flights nor claim a chargeback for airfare. The situation is different under section 75: consumers may additionally be able to recover either the cost of the flight or any additional cost resulting from their booking a replacement safari tour.

D.73 ATOL protection applies only where licensable sales were made under ATOL, and it may not operate despite travel associations and merchant acquirers believing it to be in place. This was the case when Bookable Holidays, a company which sold mainly flight or flight-plus arrangements, failed. The majority of loss in this case fell on the merchant acquirer.

D.74 The law does not require flights sold by airlines to be ATOL protected, but those which sell package holidays must provide protection. Some airlines sell holidays through a subsidiary company, such as British Airways Holidays, which holds an ATOL licence.

D.75 Some airlines offer customers the opportunity of booking accommodation (or car hire) at the same time as the flight. If they are sold as a package, the airline must meet the requirements of the Package Travel Regulations. If the components are sold separately and not combined as a package then there is no statutory protection unless the consumer has paid by credit card.

Travel insurance

D.76 Travel insurance is a voluntary insurance product subscribed by consumers who wish to insure against various risks involved in holidays and travel abroad. Most commonly, travellers are anxious to have insurance in case they require urgent medical care or fall victim to theft. However, some travel insurance policies may include financial failure insurance where one of the suppliers or organisers of the holiday becomes insolvent. The extent and limits of any such protection will be dictated by the terms of the policy.

D.77 Many airlines offer consumers the choice of purchasing travel insurance when booking flights, though the policy may not cover financial failure. This type of protection is particularly important for products where legislative protection is not in place (particularly for scheduled flights). Indeed, some ABTA members advocate a deregulated approach facilitating consumer choice: insurance products should be offered and consumers can assess the risk for themselves.

D.78 However, if statutory protections were to fall away in favour of optional insurance purchased by the consumer, a situation may arise where only some travellers are protected.

WRONGFUL TRADING IN THE TRAVEL SECTOR

D.79 Given that holiday arrangements are usually made and paid for – either partly or in full – far in advance, the risk that operators or retailers continue to accept prepayments when faced with financial difficulties is increased.

D.80 The main cases in the travel sector involving pure fraud are where a fraudster buys a small travel agent and advertises extremely cheap fares for departures far in the future then disappears. In situations like this where an ABTA member has perpetuated fraud, the organisation has liaised with the police. ABTA's position is to not provide financial protection in the case of fraud: this, along with its unwillingness to require financial protection for accommodation-only bookings, was one of the reasons it left the OFT Consumer Code Approval Scheme in 2006.

D.81 Given that an operator may also have to provide security for a bond (eg directors' house), the incentive to continue frantic last-minute trading may be decreased.

D.82 In case of payouts from the captive fund, it is important for ABTA to claim in the fraud proceedings against those individuals. For proceeds of crime they have managed to recover approximately £1 million.

REMAINING PROBLEMS

D.83 Financial protection is significantly more developed in the travel sector than other areas where prepayments are common, thanks to industry and Government initiatives in the United Kingdom and EU intervention. However, the extent and limits of this protection may be difficult for consumers to understand due to the existence of distinct regimes for package holidays depending on whether or not they involve a flight. In addition, the overlap of protection with chargeback may make it difficult for consumers to know with whom they should seek redress.

D.84 Any reform of the sector should not reduce the range of options available to retailers but should aim at providing a more streamlined and uniform protection regime. Such a risk-based approach would reflect TSI's approach to prepayment protection in its Consumer Codes Approval Scheme. Where a debit or credit card has been used to pay, a more clear attribution of responsibility between chargeback and industry schemes such as ATOL and ABTA is to be recommended.

D.85 Looking beyond the protected products (package holidays and flight-plus arrangements), we have also identified the following gaps in protection:

(1) ATOL licensees may sell products that are not subject to ATOL protection, which may cause confusion for consumers – though the ATOL Certificate assists here.

(2) Bookings made for accommodation, car hire or flights alone – either directly or through a third party – may not be protected unless they have been paid for by credit or debit card.

(3) Where consumers build packages themselves, the failure of one element of the package may leave them with other elements which are now useless but cannot be cancelled.

(4) For non-air based packages where not a member of ABTA, traders may choose to protect prepayments through insurance or trust arrangements such as the Travel Trust Association to fulfil their obligations under the PTR. However, there is little to no oversight of these arrangements.

D.86 In light of the Department for Transport's ongoing review of the ATOL scheme, and the continuing negotiations of the revised Package Travel Directive at European level, the Law Commission does not intend to further comment on financial protection in the travel sector at this time.

APPENDIX E
EXTRACTS OF CARD SCHEME RULES

VISA EUROPE

E.1 Visa Europe informed us that it was not in a position to provide us with the relevant sections of the Visa Europe Operating Regulations as they are confidential.

MASTERCARD

E.2 MasterCard publishes a publicly available guide to chargeback on its website.[1] One of the grounds on which issuers may raise a chargeback is message reason code 4855: "goods or services not provided". These rules are applicable to all countries in which MasterCard operates and are supplemented by unpublished domestic rules specific to transactions the United Kingdom.[2]

E.3 Below, we summarise the effect of these rules, which govern the relationship between a card issuer and a merchant acquirer and cannot be relied on directly by consumers.

Minimum transaction amount

E.4 A minimum chargeback amount of £10 applied to chargebacks raised before 2 August 2015.[3]

Time limits

E.5 The cardholder has 120 days from the latest expected delivery date of the goods or services to request that their card issuer raise a chargeback.

E.6 The issuer must wait until the specified delivery date has passed before charging back the transaction.[4] For example, if the delivery date is 1 June, the issuer cannot submit the chargeback before this date. If there is no specified delivery date, the issuer must wait 30 calendar days after the transaction date before charging back, and be within 120 days from the central site business date (usually one working date after the transaction has taken place).

E.7 The issuer may charge back the transaction before the specified delivery date if it is established that the merchant will not provide the goods or services because, for example, it is no longer in business or is bankrupt.

[1] http://www.mastercard.com/us/merchant/pdf/TB_CB_Manual.pdf. This guidance applies to the worldwide scheme; the rules specific to the transactions in the United Kingdom are not available online.

[2] We are grateful to MasterCard, which provided us which a copy of the UK rules in March 2014.

[3] The minimum transaction amount appeared in the MasterCard UK Domestic Rules, rule 6.1.6 (May 2014) and was removed in the UK Operations Bulletin of 2 February 2015. This does not mean that a card issuer would have refused to refund a consumer where the transaction was below £10, merely that it would not have been able to recover this amount from the merchant acquirer under the MasterCard rules.

[4] *MasterCard Chargeback Guide*, rule 3.26.1.

E.8 However, where the dispute involves non-receipt of travel services from a bonded provider who has failed, the issuer or cardholder must first attempt to obtain reimbursement from the relevant bonding authority within 120 calendar days from the date of failure.[5] This does not apply where the issuer or cardholder has already been advised that the bonding is insufficient.

E.9 Where the bonding authority does not refund the customer, the card issuer has a further 60 days from the date of the bonding authority's response letter to raise the chargeback. A copy of the response from the bonding authority, or other notification that the bond is insufficient, must be sent to the acquirer along with other supporting document.

Supporting documentation

E.10 The MasterCard rules require the card issuer to provide supporting documentation in the form of a "cardholder letter". This will be a letter from the cardholder which must set out:

E.11 The cardholder who was engaged in the transaction;

(1) A description of the goods or services the cardholder expected to receive;

(2) The expected delivery date as conveyed by the merchant;

(3) A statement that the cardholder (or someone the cardholder nominated) did not receive the goods or services that were to be provided.

E.12 Alternatively, the card issuer may complete an "expedited billing dispute resolution process" form, in which these details are taken from a consumer and recorded.

Pro-rated amount

E.13 Where services are to be provided on a continual basis, and they have been partially provided by the retailer, the chargeback amount will be calculated on a pro rata (proportional) basis.[6] This would be the case, for example, where a consumer pays upfront for a year-long gym membership and the company enters administration after six months, the chargeback amount will be limited to half of the total paid.

E.14 Where no period of service is specified (such as a lifetime membership), the total transaction amount will be spread over a period of 18 months.

[5] *MasterCard UK Domestic Rules*, rule 6.1.6 (May 2014).

[6] *MasterCard Chargeback Guide*, rule 3.26.3.