



**Law
Commission**
Reforming the law

Consumer Prepayments on Retailer Insolvency Summary

PART 1

INTRODUCTION

- 1.1 Consumers often pay for goods and services in advance of receiving them. If the business that has taken the prepayment becomes insolvent, consumers may be left with neither the item they paid for, nor any real prospect of recovering their money.
- 1.2 Consumers do not always lose out. There are many ways in which consumers may be protected – by refunds from credit and debit card issuers, by commercial decisions taken by administrators or by arrangements put in place by individual businesses. Where losses do occur they are often relatively modest amounts – perhaps a low value gift voucher. However, in some circumstances, consumers may lose hundreds or even thousands of pounds. In 2006, the collapse of savings club Farepak caused particular distress as thousands of financially vulnerable consumers stood to lose nearly a year's worth of Christmas savings.

THIS PROJECT

- 1.3 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.

Data collection

- 1.4 We started by identifying 20 large high-profile retailer insolvencies which occurred between 2008 and 2014. We gathered data available from public sources and spoke to administrators to understand how decisions were reached. We then supplemented this with a sample of 11 smaller retail insolvencies.
- 1.5 In addition, Citizens Advice provided us with consumers' perspectives on these issues, identifying 810 cases involving consumer prepayments.

Consultation

- 1.6 In June 2015 we published a Consultation Paper¹ and received 41 responses. In December 2015 we published a summary of the views expressed.²
- 1.7 We would like to thank all those who met with us or responded to the Consultation Paper and our other requests for information. We are extremely grateful for all contributions to this project.

¹ Law Commission, *Consumer Prepayments on Retailer Insolvency: A Consultation Paper* (June 2015) CP221. Available at: http://www.lawcom.gov.uk/wp-content/uploads/2015/06/cp221_consumer_prepayments.pdf.

² Available at http://www.lawcom.gov.uk/wp-content/uploads/2015/12/cp221_consumer_prepayments_responses.pdf.

Report

- 1.8 This is a summary of a more comprehensive final report, published in July 2016 and presented to Parliament with our recommendations to Government.³

RECOMMENDATIONS

- 1.9 We do not think that consumers should be protected against all losses. However, we think there is a case for limited reforms to protect consumers in the most serious cases.
- 1.10 We recognise that deciding where losses lie on insolvency is a social and political judgement. We therefore provide Government with a range of recommendations of varying strengths. These could be drawn on - in whole or in part - if the political decision was made to improve consumers' position.

Sector specific regulation

- 1.11 As we discuss in Part 2, protections for consumer prepayments are sometimes put in place in particular sectors which pose a significant risk to consumers. However, it is impossible to know in which sector the next major insolvency may fall. In today's fast moving consumer markets, we recommend that the Government should have a power to intervene to require prepayments to be protected in sectors where the risk of consumer loss merits it.
- 1.12 The Farepak collapse caused loss to financially vulnerable consumers who believed themselves to be saving with a reliable company. It caused widespread concern. Despite this, Christmas and other savings clubs remain unregulated. In Part 4, we recommend that the first use of any power to require sector specific protection should be to protect money paid to providers of these schemes.

Chargeback

- 1.13 Consumers who pay by credit or debit card for undelivered goods and services may have recourse through their card issuer, which may agree to refund the payment. These protections are of major importance to consumers in many situations, particularly following retailer insolvency. They are partly statutory (for credit card transactions of certain values, under section 75 of the Consumer Credit Act 1974) and partly voluntary (for both debit and credit card payments under "chargeback" arrangements).
- 1.14 However, consumer awareness of the chargeback scheme appears relatively low. In Part 5, we recommend that action should be taken to improve access to information about chargeback.

³ Law Commission, *Consumer Prepayments on Retailer Insolvency* (July 2016) Law Com No 368. Available at <http://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/>.

Consumers' status in the insolvency hierarchy

- 1.15 In Part 6, we consider a limited change to the statutory hierarchy governing how an insolvent business' assets are distributed to creditors on insolvency. The change we discuss would give preferential status to a small number of consumer claims.
- 1.16 We take a very cautious approach. Any change would only apply to consumer prepayments of £250 or more made to the business in the last six months before insolvency, where the consumers had no other form of protection. Essentially it would apply to payments made by cash, cheque or bank transfer, but not to payments made by card.

Transfer of ownership

- 1.17 A consumer may have paid for goods which are still in the retailer's possession on insolvency. Who then owns the goods? The rules on this issue are particularly obscure. They were codified in statute in 1893 and their substance has not been changed since.
- 1.18 In Part 7, we recommend updated rules which are somewhat more favourable to consumers. This reform would have only a limited effect, but it would provide clearer, simpler law which insolvency practitioners and shop staff would find easier to apply.

PART 2

CONSUMERS' POSITION ON RETAILER INSOLVENCY

- 2.1 Insolvency law does not give consumers any special protection. Along with trade suppliers, landlords and many others, consumers are unsecured creditors who will not receive anything until secured creditors (typically banks and investment funds) and preferential creditors (such as employees) have been paid.
- 2.2 Our analysis of insolvent retailers found that distributions to unsecured creditors tended to be derisory – often less than 1p in the pound. For example, in the case of the retailer JJB Sports' insolvency, the distribution was 0.34 pence in the pound, meaning that a consumer with a £100 claim would receive 34p. In many cases, the amount available is barely worth the cost of claiming it.
- 2.3 However, consumers are often protected in other ways. In particular:

Consumers who have paid by credit or debit card may get a refund from the bank or other institution that issued the card. The card issuer may in turn raise a “chargeback” through payment schemes such as Visa and MasterCard.¹ We found that in practice the chargeback system is a major protection for consumers.

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

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

A company may have acted to protect prepayments while it was still trading, usually by taking out insurance or a bond or by placing the prepayments in a ring-fenced trust account. This is rare in the general retail market, but common in some specific sectors.

- 2.4 Our analysis of high street insolvencies revealed two problem sectors: gift vouchers and deposits paid for furniture and other home improvements.

¹ These are the main two card schemes, though there are others such as American Express.

GIFT VOUCHERS

2.5 Most retailers sell gift vouchers, so they are often an issue on retailer insolvency. Gift vouchers were an issue in 15 out of the 20 large insolvencies we looked at. The total value of vouchers in circulation can be substantial: for example, HMV had £6.5 million in circulation when it collapsed.

2.6 However, consumer losses were not as prevalent as might have been expected. Of the 20 insolvencies we looked at:

In seven cases, gift vouchers were honoured, either by the administrator or by the subsequent purchaser. Although the law does not allow administrators to favour consumers over other creditors, administrators may act to achieve a better result for the company's creditors as a whole. Honouring vouchers may benefit all creditors where it preserves value in the brand or brings consumers into the store.

In a further two cases, gift vouchers were accepted but only as part payment. For example, during Borders' administration, consumers were required to spend double the value of their gift voucher. More recently, in the BHS insolvency, administrators adopted a similar policy,

In the remaining six cases, gift vouchers were not honoured. Reasons for this varied: in some cases there was no period of trading in administration, or honouring vouchers was not commercially viable; in others, new purchasers of the business were found at an early stage and they decided not to honour vouchers. In these six cases, over £7 million of vouchers in circulation were rendered worthless.

DEPOSITS IN THE FURNITURE AND HOME IMPROVEMENT SECTORS

2.7 Many of the largest losses concerned deposits for furniture, bathrooms and fitted kitchens. Here, many retailers have encountered financial difficulties and entered administration. The table below shows the total deposits held by seven out of the eight such retailers in our sample of high street insolvencies.

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

- 2.8 Not all these prepayments were lost. Some orders were fulfilled during a period of trading in administration (though these tended to be where only a small deposit was taken). Others were fulfilled by new buyers of the business, as occurred in the cases of retailers Dreams and Dwell. Most importantly, those who paid by debit or credit card were able to claim refunds from their card issuers.
- 2.9 The heaviest losses fell on consumers who had paid by cash or cheque, who tend to be drawn from less well-off socio economic groups. Although only some figures are available, these “cash buyers” lost around £8.5 million in the MFI insolvency and £1.5 million in Homeform. An analysis of case histories provided by Citizens Advice suggested that the average amount lost in the cases reported to them was around £700.

PROTECTING PREPAYMENTS WHILE THE BUSINESS IS TRADING

- 2.10 There are three main ways in which a business may protect consumer prepayments:

Trusts. Retailers may ring-fence consumer prepayments by placing them in trust. On insolvency, money which has been held in trust for prepaying consumers can be distributed to them rather than to creditors generally. Though an effective form of protection, trusts restrict cash flow and access to working capital. They can also be expensive and complex to establish and administer.

Insurance. Insurance cover is commonly provided in some sectors, such as new build properties, solar panels and double glazing. However, the market for prepayment insurance in the general retail sector appears underdeveloped and it may therefore be difficult to obtain on an individual basis. We have been told that the main problem is a lack of demand and that these barriers could be overcome through collective action or mandatory requirements.

Bonds. Bonds are commonly used in the travel industry, particularly by members of the Association of British Travel Agents (ABTA). However, a bond may not provide sufficient cover. ABTA supplements bonds with insurance arrangements.

- 2.11 None of the general retailers in our sample had protected prepayments in the normal course of trading (though some did so in the run-up to insolvency). However, trusts, insurance and bonding are used to protect prepayments in some specific sectors.

SECTOR SPECIFIC PROTECTION

- 2.12 Government has encouraged retailers to set up self-regulatory codes, to provide consumers greater protection than the law requires. These voluntary measures have often been seen as the way to safeguard consumer prepayments on insolvency.

CCAS codes

- 2.13 At present, the Chartered Trading Standards Institute runs the Consumer Code Approval Scheme (CCAS) whereby codes developed by trade bodies are subjected to a stringent approval process. One of the eight core criteria which CCAS codes must meet is that deposits or prepayments are protected.
- 2.14 There are currently 16 CCAS codes, to which over 32,000 businesses have signed up voluntarily. Examples include the Renewable Energy Consumer Code (covering solar panels) and codes from the British Association of Removers and the Carpet Foundation.
- 2.15 Of all the CCAS criteria, some sponsors find prepayment protection to be the most difficult to fulfil.² It can sometimes be a deal-breaker for trade bodies. For example, when the Direct Selling Association withdrew from the CCAS programme, it said that protecting the entirety of all consumer prepayments, though a desirable objective, was a “costly and commercially unrealistic one in a commercially competitive environment”.³

Other voluntary codes

- 2.16 Most non-CCAS codes do not require prepayments to be protected. However, a few schemes do provide this safeguard.⁴

New homes

- 2.17 The Consumer Code for Home Builders requires all home builders who are registered with the main home warranty providers to make arrangements to protect contract deposits paid by home buyers.

² Response of the Office of Fair Trading to Department for Business, Innovation and Skills, *Consumer Landscape Review* (May 2011).

³ Response of the Direct Selling Association to question 8 of Department for Business, Innovation & Skills, *Consumer Landscape Review* (May 2011).

⁴ For a discussion of the protections provided by the Christmas Prepayment Association, see from para 4.9 below.

- 2.18 The two largest home warranty bodies, NHBC and MDIS, will repay homebuyers' deposits up to a limit of 10% of the original purchase price or £100,000 (whichever is less). However, we were told that some other warranty bodies offer protection subject to excesses or lower limits.

Double glazing

- 2.19 There is no statutory requirement to protect deposits. However, FENSA and CERTASS, the two largest industry bodies, both require their members to do this so that the consumer is protected if the trader becomes insolvent before carrying out the work.

MANDATORY PROTECTION

- 2.20 In a few cases, consumer prepayment protection is mandatory. Businesses are required to hold prepayments on trust, or to use insurance or bonding as an alternative. Two important examples are travel and prepaid funerals.

Travel

- 2.21 Since 1972, organisers who sell holidays involving air travel must hold a licence from the Civil Aviation Authority. The Air Travel Organisers' Licence (or ATOL) remains a major protection, refunding deposits and repatriating travellers when holiday providers become insolvent.
- 2.22 Travel packages not involving air travel are now subject to regulations, which also require travel organisers to protect consumer prepayments.⁵ Organisers are given a choice of bonding with an approved trade body, purchasing insurance, or putting trust arrangements in place.

Prepaid funeral plans

- 2.23 The provision of funeral plans is a regulated activity subject to supervision by the Financial Conduct Authority (FCA). 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.⁶ In effect, therefore, the prepayments must be completely protected by trust or insurance. Otherwise, the funeral provider must be regulated by the FCA.

⁵ Package Travel, Package Holidays and Package Tours Regulations 1992.

⁶ Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, arts 59 and 60.

PART 3

A NEED FOR REFORM?

AN INFREQUENT BUT EMOTIVE ISSUE

- 3.1 Retailer insolvency is relatively rare – and even where it occurs there are several ways in which consumers may be recompensed. The total consumer detriment caused by insolvency is much less than that caused by other issues, such as unfair commercial practices.
- 3.2 Most losses are small: for example, when Zavvi collapsed, the average loss to each consumer holding a Zavvi gift voucher was only £8.12. Large and significant losses are rare, but they can occur.
- 3.3 That said, consumers are often outraged to find that money paid in good faith had simply been lost, and astonished that the law allows this to happen. When consumers find their prepayments have become worthless they tend to use terms like “fraud”, “robbery” and “theft”:

They are still accepting customers’ money and these gift cards have been purchased for which no goods have been exchanged – is this not theft?¹

WHY RE-EXAMINE THE ISSUE?

- 3.4 We have identified four arguments for re-examining the position of consumers on insolvency:

This discrepancy between consumer expectations and the law can lead to negative press coverage, swollen postbags to Members of Parliament and even public disorder.

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

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

Businesses with financial problems (who find it difficult to borrow money from sophisticated lenders) may increase prepayments from consumers to improve cash flow, despite knowing that the goods or services may never be delivered. Under the current rules, floating charge holders benefit directly from these prepayments.

¹ Taken from Citizens Advice case summary.

CONCERNS

- 3.5 On the other hand, doing more to protect consumers on insolvency is controversial. Although most respondents agreed that there was some need for change, many expressed concern about a disproportionate response.

Businesses

- 3.6 Businesses stressed the cost of protection, which they thought was often out of proportion to the detriment suffered by consumers. They were concerned that protection would deprive businesses of working capital, or make lending more expensive. It could also add administrative costs, which would be passed to consumers.

Insolvency practitioners

- 3.7 Insolvency practitioners emphasised that insolvency inevitably causes loss to many (perhaps most) creditors. They pointed to the Cork Committee report which led to the Insolvency Act 1986.² The Committee argued strongly that all unsecured creditors should be treated equally. It therefore rejected pleas for any special protection for consumers, saying that when consumers lost money they generally lost affordable sums – unlike some small businesses, for whom the retailer's insolvency may spell disaster.
- 3.8 Respondents to our consultation queried whether consumers were really more deserving of protection than other creditors.

WHICH SECTORS POSE SIGNIFICANT RISK?

- 3.9 In the Consultation Paper, we asked whether there were sectors in which consumers were particularly vulnerable to significant losses. Four respondents mentioned Christmas savings schemes. Otherwise consumers identified a wide range of sectors, including weddings, the building trade, and tickets for concerts and sporting events.
- 3.10 In the utilities sector, it is common for consumers to have a credit balance with their gas or electricity supplier, particularly those who pay through fixed monthly direct debit payment plans (where overpayments during the summer meet winter fuel bills). Where payments are made by direct debit, consumers are not protected in the same way as they would be if they paid by credit or debit card.

A BALANCED APPROACH

- 3.11 When companies become insolvent, it is inevitable that losses will fall on creditors. We do not think that consumers can or should be protected against all losses. Below we explain why we do not think that all gift vouchers should be protected.

² *Insolvency Law and Practice: Report of the Review Committee* (June 1982) Cmnd 8558.

- 3.12 However, we do recommend limited protections against the most extreme cases. Protection may be justified by a variety of factors: where the consumer is not aware of the high risk of insolvency; where chargeback protection is not available; where the losses are particularly large; or where insolvency would cause particular hardship. One reason why the collapse of the Christmas savings club Farepak caused such concern was that families were deprived of money for their Christmas celebrations.

Gift vouchers

- 3.13 When a high street retailer becomes insolvent, one of the most high profile issues is what happens to the gift vouchers in circulation. The announcement that BHS had entered into administration gave rise to many articles focussed on consumer rights.
- 3.14 Consumers are often unaware of the risks of losing vouchers and are not in a position to judge a retailer's solvency risk when making the purchase. Some consultees, including consumer groups, argued that all vouchers should be regulated, and the funds protected.
- 3.15 However, gift voucher losses were relatively uncommon, and when they did occur consumers usually lost only small amounts. Mandatory protection for all gift vouchers would be costly and disproportionate to the detriment caused. The cost would inevitably be passed on to consumers.
- 3.16 Gift vouchers are issued by a wide range of retailers, including many small and micro businesses, such as nail bars or health spas. Smaller businesses would find any additional regulations particularly difficult to comply with.
- 3.17 Rather than attempt to protect consumers against losses, we think it would be helpful to increase awareness among consumers that vouchers are not, despite appearances, the equivalent of money. This may encourage consumers to spend vouchers quickly and help them understand that, in the (relatively unlikely) event of the retailer's insolvency, they may lose out.

PART 4

CHRISTMAS SAVINGS AND OTHER SECTOR SPECIFIC PROTECTION

- 4.1 In many sectors, voluntary schemes have provided consumers with important protection. However, voluntary schemes can only go so far. Regulation may be necessary to ensure a level playing field between businesses, as it is too easy for good traders to be undermined by their less scrupulous rivals. Regulation, or the threat of it, may also encourage industries to take concerted action to overcome the barriers to obtaining insurance.

A POWER TO REQUIRE SECTOR SPECIFIC REGULATION

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

- 4.3 We would envisage that the power would also set out:

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

the general consequences of a business in a relevant sector failing to protect the prepayments; and

the manner of enforcement.

Types of protection

- 4.4 We think that any legislation should allow for protection of prepayments by any of the methods we have identified: bonding, insurance or trust arrangements. Any trust should be required to have at least one trustee who is independent of the company.

Enforcement

- 4.5 As with other consumer protection measures, we envisage that Trading Standards would be primarily responsible for enforcement. In addition to a power to prosecute, Trading Standards would have civil enforcement powers. In some cases the Competition and Markets Authority, other sector specific regulators and trade bodies should also play a role.

CHRISTMAS AND OTHER SAVINGS SCHEMES

- 4.6 When Christmas savings club Farepak collapsed in 2006 it owed £37 million to around 100,000 consumers, many of whom were on low incomes. They had saved an average of £400 with Farepak, and some had saved £2,000. Although savers eventually obtained around 50 pence in the pound, 70% of this came from compensation funds set up to meet hardship, and it took six years for these payments to be distributed.

- 4.7 Consumers who are saving money expect protection, as they would have if they put their money in a bank. However, the protections available to bank customers are not available to customers of savings schemes which provide hampers or retail vouchers rather than cash at the end of the saving period.
- 4.8 We think that the first use of the new power should be to protect those who contribute to schemes which provide goods, services or voucher schemes as a form of savings.

Voluntary protection

- 4.9 After Farepak collapsed, the Department for Business, Enterprise and Regulatory Reform liaised with the industry to develop the Christmas Prepayment Association (CPA). It currently has six members, who all agree to adhere to a voluntary code of practice. Members must hold consumers' savings in a trust overseen by trustees, half of whom must be independent of the member. The trusts may be subject to draw down provisions which allow operators to use some money for trust overheads and other working capital.
- 4.10 However, there are other providers of Christmas savings schemes – from smaller retailers to large supermarkets – which are not part of the CPA and which have not committed to keeping the money in trust. Some supermarkets which run savings schemes, such as the Co-operative, do protect consumers' savings, but others do not. Given the public anger caused by the Farepak collapse and the financial vulnerability of many of the consumers who use such schemes, it is worrying that some businesses continue to operate Christmas savings clubs without protecting consumer prepayments.
- 4.11 We think this, combined with consumers' general perception that savings should be and are protected, demonstrates the need for Government intervention. Our proposal for greater protection was widely supported on consultation.

Defining “savings” schemes

- 4.12 The particular danger posed by unregulated “savings schemes” is that consumers think of them as suitable for saving in place of, for example, a dedicated bank account. We therefore think that the definition should focus on how a scheme is perceived by consumers.
- 4.13 As well as Christmas clubs, we have come across other examples where vouchers were marketed as savings schemes. For example, one travel company advertised its gift cards as “a great way to save” towards a special holiday, while a toy shop described its re-loadable gift card for children as a “piggy bank”. We have no concerns about holiday or toy shop vouchers as such but we do not think they should be marketed as suitable for saving unless the funds are protected.
- 4.14 We think that regulation should cover any scheme which takes consumer prepayments in return for goods, services, or vouchers, and which is either:
- marketed as being suitable as a savings mechanism; or
 - would be understood by “an average consumer” as being a form of savings.

- 4.15 The average consumer test is commonly used in consumer law to signify a hypothetical consumer who is reasonably circumspect and well-informed. It is therefore a relatively high threshold, which would not depend on misguided or misinformed perceptions.

The type of protection

- 4.16 We recommend that businesses should be given a choice about how to protect payments, which may be by trust, insurance or bond. We envisage that most businesses would opt to hold consumers' money on trust as the CPA code requires.

Smaller retailers

- 4.17 Several consultees were concerned about the potential impact of regulation on small businesses, such as local butchers who operate a Christmas club.
- 4.18 We can see that small businesses may find the costs of trust or insurance arrangements prohibitive and that there is a case for excluding them from any regulation. On the other hand, allowing a very small business to take large sums from consumers without requiring protection, leaves scope for serious losses. We think therefore that any exclusion for microbusinesses should be limited to small prepayments. We suggest £100.

PART 5

CHARGEBACK

- 5.1 A consumer who has paid by credit or debit card for undelivered goods has the ability to recover money through their card issuer. 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 credit card provider liable for the retailer's breach of contract and/or misrepresentation.
- 5.2 For all types of card transactions, whether made by debit or credit card and irrespective of the value of the transaction, the card schemes (such as Visa and MasterCard) voluntarily provide a system of "chargeback". This allows a card issuer to ask the merchant acquirer (which processes sales on behalf of the retailer) to reverse a payment made by card. Merchant acquirers are constantly assessing retailers' insolvency risk and will hold back funds to pay for refunds where they consider the insolvency risk to be real.
- 5.3 Our analysis showed that the chargeback system often results in considerable sums being refunded to consumers on retailer insolvency and represents a very important protection for consumers.

A VOLUNTARY SCHEME

- 5.4 For all debit card transactions and for credit card transactions outside the financial limits, the chargeback process is voluntary. It is part of the commercial arrangements offered by the card schemes. The card scheme rules govern the relationship between the card issuer and merchant acquirer. Because the consumer is not a party to these arrangements, chargeback is not a right for the consumer to enforce.
- 5.5 In practice, however, the Financial Ombudsman Service (FOS) requires card issuers to deal with consumer requests for refunds fairly, within the terms of chargeback provisions set out in the scheme rules. The FOS has confirmed that, in the case of a retailer insolvency, it is prepared to require a card issuer to compensate a consumer if it has unreasonably refused to refund money which it could have recouped through a chargeback claim. The approach of the FOS means that chargeback arrangements are not as voluntary as they first appear.
- 5.6 We think that the current system generally works well and would not be improved by putting it on a statutory footing. The majority of respondents to our consultation agreed.

THE NEED FOR TRANSPARENCY

- 5.7 The main problem with chargeback is lack of transparency and consumer awareness. We identified four channels for providing consumers with greater information on chargeback. On consultation, our suggestions were very well supported.

Information from insolvency practitioners

- 5.8 We recommend that insolvency practitioners should provide consumer creditors with more information about chargeback when a retailer becomes insolvent.
- 5.9 We would expect insolvency practitioners to provide a prominent statement on the website of the insolvent retailer. The statement should inform consumers about chargeback, and advise those who made a prepayment by card to contact their card issuer. It would also be helpful to remind consumers to act promptly and provide a link to further information provided by the card industry (as discussed below).
- 5.10 Some insolvency practitioners already provide this information, but others were worried that it might be seen as favouring one group of creditors over another. The Insolvency Service has agreed to produce guidance for insolvency practitioners on the information they should provide. We hope that the regulatory bodies, such as insolvency professional body R3 and the Institute of Chartered Accountants in England and Wales (ICAEW), will reinforce this guidance and monitor compliance with it.

Information from card issuers

- 5.11 We recommend that card issuers should provide prominent and easily accessible information about chargeback.
- 5.12 The UK Cards Association (UKCA), the trade association for the UK cards industry, considers that it is best placed to take this forward. We recommend that the UKCA prepare a code of best practice for card issuers on providing information about chargebacks and evidential requirements for raising a chargeback.

A guide about how chargeback works

- 5.13 While the details of the Visa and MasterCard card scheme rules are available online, these are commercial agreements between sophisticated parties and are not designed to be read or understood by consumers. We would like to see a publicly available authoritative guide providing the information which is relevant to consumers in clear, accessible language.
- 5.14 The UKCA has agreed to take this forward.

Evidence of insolvency

- 5.15 To substantiate a chargeback claim, card issuers will ask consumers for certain information about the claim. However, anecdotal evidence suggests that consumers are sometimes asked to provide evidence which they do not have and cannot access. We recommend that card issuers should agree an approach to their evidential requirements. This should include a standard document which insolvency practitioners can make available on an insolvent retailer's website to prove the fact of insolvency itself.
- 5.16 We think that the UKCA is best placed to resolve this issue, in discussion with insolvency practitioners.

NEW FORMS OF PAYMENT

- 5.17 The Second Payment Services Directive¹ encourages new payment methods in addition to credit and debit cards. While this promotes consumer choice and may reduce costs, not all of the new methods offer the same protection as cards.
- 5.18 Smartphone payment apps are typically linked to a debit or credit card and therefore users still benefit from chargeback. PayPal operates its own Buyer Protection arrangements which operate in a similar way to chargeback. However, direct bank transfers between accounts – which are being made easier by new apps such as Zapp and Pingit – do not involve any card payment, so chargeback protection is not available.
- 5.19 We appreciate the benefits of account-to-account payments. They are marketed as easy, fast and secure methods of payment and they avoid any card transaction fees. However, it is possible that they will appeal to the riskiest businesses or sectors. This has the potential to introduce new and unexpected insolvency risks for consumers.
- 5.20 In the next Part, we make the case for a limited preference on insolvency for consumers who cannot make use of the chargeback system because they have paid by cash, cheque or another payment method which does not give access to the chargeback scheme.

¹ Directive (EU) 2015/2366 on payment services in the internal market:
http://europa.eu/rapid/press-release_IP-15-5792_en.htm?locale=en.

PART 6

CONSUMERS' STATUS IN THE INSOLVENCY HIERARCHY

- 6.1 Once an insolvent business has been liquidated or sold off in parts, and its assets realised, any remaining money is distributed to creditors in the following order:

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

Expenses of the administration or liquidation (including the administrator's fees and costs such as rent or VAT incurred whilst trading in administration);

Preferential creditors (typically employees and employees' schemes);

Floating charge holders (typically banks and similar institutions), less the prescribed part which is a statutory portion set aside for unsecured creditors;

Unsecured creditors (including consumers, contractors, landlords and HMRC). In most cases the only money available for unsecured creditors is the prescribed part;

Shareholders and members.

REFLECTING POLITICAL PRIORITIES

- 6.2 A political decision has been made to give employees preferential status because of the particularly vulnerable situation in which they find themselves following their employer's insolvency, especially if pension contributions, holiday pay and wages have not been paid. This justifies their elevated position in the hierarchy.
- 6.3 Meanwhile, secured creditors have taken steps to protect themselves in the event of insolvency by taking a security specifically to put themselves ahead of other creditors. The granting and taking of security plays a crucial role in ensuring that credit is available to businesses who seek it, either at all or on favourable terms.
- 6.4 The very nature of insolvency means that there is not enough money to repay all creditors. Any change to the hierarchy to promote one group would necessarily have an impact on those further down the list.
- 6.5 This leads to a difficult decision about whether some consumer claims should be paid in preference to claims from other creditors. In the United States, consumers are granted a priority over other unsecured creditors, where claims arise from the deposit of money for goods or services which were not delivered or provided.¹

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

A LIMITED CHANGE TO THE INSOLVENCY HIERARCHY

6.6 We do not argue that all consumer claims should be given preferential status. The statutory hierarchy balances many competing interests and, on a business' insolvency, some innocent parties will always suffer loss.

6.7 There are three arguments for increasing the status of consumer claims:

Consumers are often particularly vulnerable and may suffer unexpected hardship. However, other unsecured creditors such as independent contractors and small suppliers may be equally or even more disadvantaged by a retailer insolvency so this in itself is not a sufficient argument;

Prepaying consumers provide an injection of cash and are effectively lending money to the business, but they are not in a position to assess the credit risk; and

The current statutory hierarchy sets up a perverse incentive. Continuing to take prepayments during a period of severe financial instability is likely to produce a direct benefit to floating charge holders and a direct loss to consumers unless other arrangements are put in place.

6.8 We think there is a case for giving preferential status to a limited category of consumer claims where retailers have taken large sums by cash or some other unprotected method of payment shortly before becoming insolvent.

6.9 We recommend that Government should consider giving preferential status to claims which satisfy *all* of the following criteria:

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

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 payment is made *during the months* leading up to insolvency, when the financial problems facing the company are likely to have become apparent. We have been persuaded that a six month limit would be more appropriate than the three months we suggested in consultation. This would give more protection to consumers making prepayments over a longer period and would align with insolvency legislation on preferences.

Administering a large number of small claims could be extremely expensive and time consuming. The claim should therefore be *sufficiently large* to justify the costs of distribution. We suggest that claims over £250 should qualify. We have raised our suggested limit from £100 in response to arguments from insolvency practitioners that too many smaller claims would add time and cost to the distribution process.

The consumer *is not protected by other means*, such as chargeback.

6.10 This preference would not affect fixed charge holders, the expenses of the administration or employees. We think it should rank below preferential claims from employees, but above floating charge holders.

CONCLUSION

- 6.11 Giving preferential status to consumer claims involves a value judgement. In essence, the question is how far losses should fall on consumers or on banks and other institutional lenders. That is a political decision, which should be made by those who are elected to make these judgements.
- 6.12 If the Government does wish to act to protect consumers on retailer insolvency, this “limited preference” would send a strong consumer protection message. Its advantage is that it would apply to all classes of business. It would also address the risks introduced by new account-to-account payment methods.

PART 7

TRANSFER OF OWNERSHIP

- 7.1 In some cases, a consumer will have paid for goods which are still in the retailer's possession when it becomes insolvent. Questions then arise about who owns the goods. If ownership has been transferred to the consumer, the goods will not form part of the retailer's general asset pool: instead they belong to the consumer and should be made available to them.

CURRENT LAW

Ownership and risk

- 7.2 The Consumer Rights Act 2015 made changes to the rights of consumers when purchasing goods. However, the rules on transfer of ownership were not changed. They are still contained in the Sale of Goods Act 1979 and are substantially the same as when they were first codified in 1893.

Specific goods

- 7.3 Section 61(1) of the 1979 Act defines specific goods as goods "identified and agreed upon at the time a contract of sale is made".
- 7.4 For specific goods, ownership generally passes at the time the contract is made, so long as the goods are in a deliverable state. Where the seller is bound to do something to put the goods into a "deliverable state", ownership does not pass until that thing has been done and the buyer has been notified.

Unascertained goods

- 7.5 In many cases, the specific goods to which the contract relates have yet to be identified. For example, where a consumer buys goods online, the retailer has the freedom to select which item among the many in the warehouse will be used to fulfil the contract. This is a contract for "unascertained goods". Alternatively, the goods may not yet have been made ("future goods").
- 7.6 Here ownership generally passes when goods are "unconditionally appropriated" to the contract. It appears that setting aside or labelling goods for dispatch is insufficient; rather, goods are "unconditionally appropriated" when the seller delivers the goods to the buyer or carrier, though other acts may also be sufficient.

RECOMMENDATIONS FOR REFORM

- 7.7 We think that the current rules are unduly complex and uncertain. They were developed in a commercial context and are problematic to apply to consumer cases. Our discussions with stakeholders and responses to the consultation suggested possible misunderstandings and disagreements about the effect of the current law. We think there are good arguments for introducing clearer, updated statutory rules on transfer of ownership.

Specific goods

- 7.8 We recommend that, in consumer contracts for specific goods, ownership should pass on conclusion of the contract, even where the seller agrees to do something further to the goods (such as adapt the goods to the buyer's specifications).
- 7.9 We think that removing the requirement that goods be in a deliverable state would provide clarity and make it easier for insolvency practitioners to release stock to prepaying consumers where appropriate. This would also address the perception that the law is unjust. It would be fairer to consumers and more aligned to common expectations.

Unascertained goods

- 7.10 For unascertained or future goods, we said in consultation that ownership should be transferred when the goods are "identified" for the fulfilment of the contract. This would include labelling the goods, setting them aside for the customer, or altering them for the customer's specification.
- 7.11 Consultees felt that merely replacing the word "unconditional appropriation" with the word "identification" would not bring the clarity which administrators and shop staff need. We therefore recommend that any legislation should include a non-exhaustive list of events and circumstances which would be sufficient to identify goods to the contract including where:

the goods have been altered to the consumer's own specifications;

the goods have been labelled with the consumer's name or set aside for the consumer in a way which is intended to be permanent;

the consumer is told that goods bearing a unique identifier will be used to fulfil the contract;

the consumer has physically examined and accepted the goods;

the goods are handed to a courier to be delivered to the consumer;

the goods are delivered to the consumer.

Payment

- 7.12 The current default rules on transfer of ownership do not require goods to be paid for before ownership is transferred. However, the retailer or administrator is not obliged to release the goods until the consumer had paid for them in full.¹
- 7.13 We recommend retaining this approach. Even where ownership had transferred, the seller would have a right to retain the goods until the whole of the price has been paid.

¹ Sale of Goods Act 1979, s 39(1).

Mandatory rules

- 7.14 We recommended that any contract term which would put the consumer in a worse position than they would be in under the suggested new rules should be of no effect.