Gift Vouchers & Deposits:

Enhancing consumer protections in insolvency

July 2013

At the end of 2012 and beginning of 2013 the UK saw some of the biggest High Street casualties of recent years as Comet, Jessops, Blockbuster and HMV entered administration. As well as concern for the thousands of jobs at risk, there was outrage from the public when those with vouchers and gift cards found they were unable to spend them. This has led to calls from MPs and consumer groups to enhance the protections available for consumers in an insolvency situation.

In this paper, R3 looks at the current treatment of gift vouchers and consumer deposits and considers the difficult balance between enhancing protections for consumers whilst protecting business rescue and promoting a healthy lending culture.

What happens at the moment?

When Insolvency Practitioners are appointed to a business they have a statutory duty to maximise returns to the businesses' creditors. In most cases the best outcome is rescuing the business, via a sale as a going concern. The ability of an Insolvency Practitioner to rescue a business is often dependent on having enough money, or access to funding, to trade on until a buyer can be found.

After being appointed to a retail business, the Insolvency Practitioner then has to take a commercial decision over whether or not to accept gift vouchers. This decision will be based on a number of different factors, including the number of vouchers in circulation, the impact on other creditors, the likelihood of achieving a rescue and the relationship between the business and its consumers. In situations where there are a significant number of gift vouchers in circulation, accepting vouchers whilst administration trading continues could significantly erode the value of the assets for creditors (as valuable stock would be given away to redeem vouchers). It may also deter potential buyers, who might not wish to be encumbered with the obligation to accept vouchers; or cause a purchaser to reduce the price they are willing to pay for the business, to compensate for the vouchers in circulation.

It is sometimes the case that the administrator will start to accept gift vouchers later in the process after the business has begun trading in administration, in order to preserve good will and customer relationships. This decision will be made after the administrator has reviewed the business and carefully weighed up the commercial benefits and risks; including any damage that may be done to the brand name if vouchers are not accepted.

If vouchers are not accepted, consumers become unsecured creditors of the insolvency along with HMRC and other businesses and suppliers owed money by the company. In an insolvency those owed money are paid in a strict order of priority determined by statute. There is rarely enough money to pay everyone and the lower a creditor's position in the priority order, the less likely they are to recoup the money they have lost. Unsecured creditors are paid after secured and preferential creditors but in many cases receive no dividend at all.

"In Blockbuster we took the decision to honour gift vouchers. As a local business, each customer had a relationship with its own local Blockbuster store. The distinction between loyal and transient customers meant that on balance it made commercial sense to accept vouchers. If we had failed to honour gift vouchers we would have seriously damaged the relationship between the consumer and the store and it would have resulted in a lot of negative press. This could have ruined the value of the brand in the eyes of a prospective purchaser. To get the best outcome for creditors we needed to secure a buyer at the best price, so we were keen to avoid this scenario at all costs."

Lee Manning, Blockbuster administrator

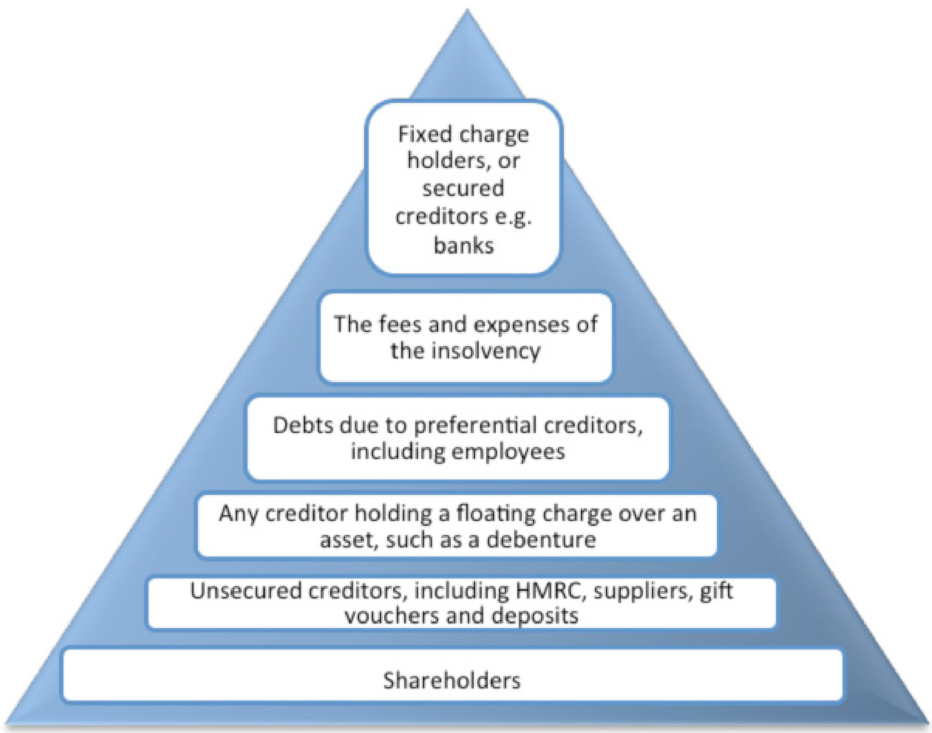
What happens at the moment?

Existing protections

Under the Consumer Credit Act 2006, consumers who pay for their vouchers by credit card will be protected - Section 75 of the Consumer Credit Act states that a credit provider is equally responsible, along with the retailer or trader, for any breaches of contract or misrepresentations, provided the item costs between £100 and £30,000. However, for those individuals paying by cash, the law still lacks vital protections. Unfortunately, it is often those people who can least afford it that lose money in these circumstances as they do not have access to credit or debit cards.

In addition to protections within the Consumer Credit Act, consumers may be able to recoup some or all of their losses if they are covered by chargeback. Chargeback is not enshrined in law, but it is part of what is known as Scheme Rules, which participating banks subscribe to. It applies to debit cards, although exact rules may vary between the Visa, Maestro and American Express networks. Chargeback also applies to credit cards and is particularly useful where section 75 is not applicable – for goods costing less than £100, for instance. However, in respect of gift vouchers the benefit of chargeback protection is to the purchaser of the voucher, not the voucher holder, who typically receives a voucher as a gift.

The order of priority for creditors



Enhancing consumer protections - current proposals

Changing the order of priority

When examining the position of consumers in an insolvency situation, one of the most important aspects to consider is the knock-on consequences for other creditor groups.

It has been suggested by various commentators and Parliamentarians, that to help protect consumers in insolvency, unredeemed gift vouchers and consumer deposits, which have not been honored, should become a preferential creditor and legislation should be amended so that consumers with vouchers or deposits are paid ahead of other unsecured creditors. The law sets out clearly the order in which creditors should be paid and any change which alters the order of priority may have a serious impact on lending and the small business community.

In addition, these proposals will not fully protect these individuals in the event of insolvency. The order of priority determines the order of dividend payments at the end of the insolvency process; this does not necessarily mean that gift vouchers must be accepted when the business is still trading. In addition, there is no guarantee that there will be sufficient assets in the insolvent company to pay the preferential creditors in full and it could be a long and costly process to find the creditors, agree the claims and pay the preferential dividend.

Impact

R3 has serious concerns about the consequences of these proposals and believe they will have a negative impact on the following areas:

Lending
Preferential creditors rank directly ahead of floating charge holders (typically banks and other lenders for assets subject to a floating charge e.g. stock, moveable plant equipment and trade debtors). The lending environment is underpinned by lenders having the confidence that businesses cannot simply accrue debts and then walk away from them. The ability to borrow money at an affordable rate is based on this principle. If the category of preferential creditors expands it will potentially have a considerable impact on the amount returned to lenders in retail insolvencies and hence the margin of comfort they will require over the assets they lend against. A likely consequence of this is an increase in the cost of credit to retailers and a reduction in its availability.

Business community
As unsecured creditors small businesses and other suppliers are paid last in an insolvency situation and as such often face considerable losses when a business collapses. If the range of preferential creditors expands to include vouchers and deposits in a retail situation, the amount available to unsecured creditors will be reduced yet further. At a time when Government is looking to the private sector to fuel growth, the impact of this change on the small business community should be carefully considered.

Employees
Under current legislation, employees are essentially the only preferential creditors in an insolvency for arrears of wages and holiday pay. However, if the rights of gift voucher holders are enhanced and they too become preferential creditors, this could potentially reduce the money available to employees. This would be a particular problem in those cases where there is only enough money to pay preferential creditors as they currently exist. A large claim for gift vouchers and deposits could quickly dilute the pot available, thereby reducing the money available for employees.

Enhancing consumer protections - alternative solutions

Whilst insolvency doesn't necessarily herald the closure of a business, all creditors are likely to lose out to varying degrees. The current order of creditor priority has been set out in statute and carefully considered to take into account lending and other public policy decisions, such as the protection of employees. Extending the protections available for one class of creditor above others will inevitably have knock-on consequences. However, if public policy determines that consumers and holders of gift vouchers should be given enhanced protections in an insolvency, R3 believes that the possible solutions detailed below should be considered:

1. Bonding

To protect consumers, businesses that issue gift vouchers or take deposits from consumers could be obliged to purchase a protection bond, which would honour these in the event of insolvency. The cost of this bond is likely to be determined by the average level of vouchers and deposits outstanding to any particular retailer and will be subject to an actuarial risk assessment based on the company's financial history and reputation. The insurance industry would be responsible for pricing this bonding on a company by company basis and the proceeds would be ring-fenced for the benefit of voucher holders, or individuals with deposits that have not been honoured by the Insolvency Practitoner.

Pros: Larger insolvencies, with a disparate group of creditors often take several years to settle before a dividend can be paid out. The advantage of bonding is that in the event of insolvency, consumers should be paid relatively quickly, as the bond proceeds would be held in trust by the insurer. The administrator or liquidator should be empowered under the insurance policy to agree consumer claims and distribute the proceeds to the claimants. The challenges faced by the insolvency/insurance industry would be relatively straightforward when dealing with deposits, but potentially far more complicated in respect of vouchers, as retailers typically do not keep records of those they have sold vouchers to. For this reason, the retailer should be insured for a total sum based on estimated liabilities.

It is envisaged that under the bonding proposals the voucher/deposit holder would be the beneficiary of the bond and would present their voucher in order to make a claim. This would avoid the problem which exits under the current system, that the creditor in the insolvency is arguably the purchaser of the voucher, rather than the holder. This often makes it very difficult to trace all those who are owed money and may cause money to be paid twice.

In addition, bonding should not impact on the normal running of a business. This change could be achieved through an amendment to the Consumer Credit Act, or a non-regulatory solution similar to the travel industry, whereby a trade association financially protects and insures its members, who in turn pass this protection onto their customers.

Enhancing consumer protections - alternative solutions

Cons: This solution would require support from the insurance industry and there will be an associated cost to retailers, which would have to be absorbed by price increases passed on to the consumer. Start-up businesses and those with a poor credit rating could find it difficult and costly to find an insurer willing to provide a bond, however this could be dealt with via an exemption for small or micro-businesses. In addition, in reality many vouchers go un-claimed or get lost, it is therefore conceivable that the sum insured (which is likely to make assumptions about the percentage of vouchers lost) may be insufficient to meet all the claims if every voucher holder were to claim in an insolvency.

2. Ring-fencing

Money accepted for gift vouchers and deposits could be ring-fenced and kept in a trust account account, similar to a client account.

Pros: This would have the benefit of protecting consumer money and would allow gift vouchers to be accepted immediately, or consumers to be reimbursed quickly, and in full, should the business enter a formal insolvency procedure.

Cons: Retailers often depend upon the revenue generated by vouchers, and in particular deposits placed against customer orders, to provide working capital for their businesses and give them the confidence to place orders on their suppliers. This could create a material adverse impact on business cash-flow, which for some businesses may have a knock-on effect on the ability of the business to continue to operate. This would have a particular impact on retailers in the furniture sector where deposits and long-lead times are typical. In addition, relying on management to ensure client accounts are separate and properly reconciled would be time consuming and costly.

3. Extend Consumer Credit Act protections

The protections for consumers enshrined in the Consumer Credit Act could be extended to safeguard purchases under £100.

Pros: Many gift vouchers fall under the £100 threshold for Consumer Credit Act protections and therefore the protections in place would not be applicable. Whilst the Chargeback scheme may cover certain purchases under £100, made on credit or debit cards, this is not enshrined in law and the terms vary depending on the participating banks. Extending the Consumer Credit Act protections to include purchases made under £100 would help protect those who had purchased vouchers using a credit or debit card.

Cons: This would do very little to protect those consumers who pay by cash, or are unable to access credit. In addition, it would be the voucher purchaser who would benefit from this change, rather than the holder. It is also conceivable that the additional risk to the credit card companies would mean that they would insist on greater claw-back from reserves from retailers to protect their liability.

This policy should be coupled with improved education for consumers, highlighting the risks of making purchases using cash.

Conclusion

In an insolvency, by its very nature, there is simply not enough money to go around and pay everyone in full. A consumer left with a useless gift voucher or deposit is one of hundreds of thousands creditors in the same position; from small businesses who are owed money for stock, to landlords, employees and even the 'tax man'. In an insolvency not everyone can be protected and it is clear that there is no silver-bullet to protect consumers with deposits or gift vouchers - there will always be complications and knock-on consequences. However, if it is decided that the insolvency regime should protect consumers above other creditors, we would urge the Government to consider the options detailed in this paper and to mitigate, as far as possible, the resulting impact on bank lending and the business community.

About R3

R3, the insolvency trade body, represents over 97% of insolvency practitioners. R3's full members are all regulated by their recognised professional bodies, they can be licensed insolvency practitioners, solicitors, chartered accountants or certified accountants. They have extensive experience of helping businesses and individuals in financial distress.