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Dr Jane Thomson
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

18 March 2016

By email: committee.sen@aph.gov.au

Dear Dr Thomson

Inquiry into the causes and consequences of the collapse of listed retailers in Australia ('the Inquiry')

KordaMentha has had wide experience in the Australian retail sector, both in the external administration context and in advisory roles, including the facilitation of many consensual restructures of retailers. Accordingly, this allows us to contribute to the Inquiry based not just on our considered opinion, but on our familiarity of the issues that are being deliberated in the Inquiry.

Current legislation

Gift cards and laybys are generally considered a liability of a company and under the Corporations Act they are unsecured creditors and do not attract a priority over other classes of creditors as set out in section 556 of the Corporations Act.

Any change in legislation to improve the position of holders of gift cards or layby would be at the expense of creditors who are currently entitled to a priority position, such as employees, the Commonwealth Government where it has paid out employee entitlements, secured creditors and would reduce any available funds to other unsecured creditors.

Effect of external administrations on creditors

We have examined statistics compiled by Australian Securities and Investments Commission ('ASIC') about the effect of external administrations on creditors based on reports lodged by external administrators. According to *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015)* released by ASIC in November 2015, key statistics include:

- 32.2% of external administrations estimated the deficiency to be between $50,001 and $250,000[1]
- 19.8% of external administrations estimated the deficiency to be between $250,001 and less than $500,000[2]

[1] Table 34: Initial external administrators' reports – amount of deficiency by industry (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

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- 30.2% of external administrations estimated the deficiency to be between $500,000 and less than $5 million[3]
- 42.6% of external administrations had amounts owing of superannuation[4], which ranks equally in priority to unpaid wages to employees
- In 92.9% of external administrations, there was no dividend to unsecured creditors (94.0% for the retail sector)[5]
- In 4.2% of external administrations, the dividend to unsecured creditors was less than 11 cents in the dollar (similar for the retail trade industry)[6]

Information on distributions to employees was not available from ASIC, however information on the Fair Entitlement Guarantee program[7], for the period from 1 July 2000 to 30 June 2013, shows that $1.5 billion was distributed to employees under various schemes, with less than $200 million (13%) being recovered.[8] This would indicate that generally there are insufficient assets to make a distribution to employees that cover all their entitlements. If there was a change in priority to gift card holders or layby holders to place them in a position in priority to employees, the return to employees of their entitlements would be reduced. It would also reduce the Commonwealth Government's recovery of amounts distributed through the Fair Entitlements Guarantee program.

Effect of external administrations on gift card holders

According to an online survey of 1,295 adults conducted by Retail Decisions Australia, the average value loaded on a gift card was $57.[9] Whilst it is likely that the average value loaded on a gift card has risen since 2010 when this survey was conducted, based on the face value of gift cards generally available of $30, $50 and $100, it is unlikely that the average value has changed so significantly that the loss of a gift card's value through insolvency would be material in the majority of cases.

Whilst the loss of a gift card would be upsetting and disappointing, the effect of a loss of a gift card is unlikely to be more than this in the majority of circumstances. It would be hard to argue that a gift card holder's loss is greater than the loss of an employee not only of their entitlements, but the loss of employment and all the uncertainty and stress that entails, that would justify giving a gift card holder priority over an employee. Whether a gift card holder should benefit from a priority over other unsecured creditors, would again be hard to justify.

It is likely that the costs associated with dealing with gift card holders would be substantial due to the sheer volume of low value claims and the adjudication and distribution procedures involved, thus reducing the amount of funds available to lower ranking creditors.

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[2] Table 34: Initial external administrators' reports – amount of deficiency by industry (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

[3] Table 34: Initial external administrators' reports – amount of deficiency by industry (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

[4] Table 36: external administrators' reports – Amount owed in unpaid superannuation entitlements (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

[5] Table 40: external administrators' reports – Amount payable to unsecured creditors – Cents in the dollar dividend by industry (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

[6] Table 40: external administrators' reports – Amount payable to unsecured creditors – Cents in the dollar dividend by industry (1 July 2014 to 30 June 2015), *Report 456: Insolvency statistics: External administrators' reports (July 2014 to June 2015*, Australian Securities and Investments Commission, November 2015

[7] The Fair Entitlement Guarantee program is the current program where the Commonwealth Government advances funds to employees of certain external administrations and then is subrogated into the position of those employees.

[8] Paragraph 2.46, *ANAO Report No. 32 2014-15 Performance Audit: Administration of the Fair Entitlements Guarantee*, Australian National Audit Office, 23 April 2015

[9] Horne, D 2010, 'Retail Decisions Prepaid Market — the Australian Gift Card Market', Retail Decisions and Global Prepaid Exchange

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Alternative avenues of recovery may be available for gift card holders. The most likely possibility is for gift card holders to apply for a credit card chargeback if the purchase was made by credit card. The gift card holder can apply to its credit card issuer to have the credit card transaction reversed, where the goods or services have been paid for but not supplied. The credit card companies may then be entitled to the priority (depending on how the legislation is drafted).

Effect of external administrations on layby holders

There is not similar information about the average value of layby amounts. However, it is likely that the average value of laybys would be greater than gift card holders. However, with the increase in financing offers for household goods, such as ‘buy now with two years’ interest free’, the incidence of laybys may have reduced in this category. As these offers allow the consumer to take possession of the goods at the time of entering into the arrangement and the financing is generally offered by a third party, the number of layby holders affected by insolvency would not be as significant as in the past.

For the same reasons as outlined above, it is hard to argue that a layby holder should be entitled to priority over an employee or other unsecured creditors.

The avenue of credit card ‘chargeback’ may be more successful for layby holders than gift card holders as there will generally be more documentation available to substantiate a chargeback application. It may also be that credit cards are more commonly used in relation to laybys than gift cards due to higher transaction values. However this would not hold true when the layby arrangement is being used as the form of credit, rather than for other purposes, such as holding of goods by the retailer or dispersing the payment period.

Proposal: Placing an obligation on external administrators to honour gift cards

In our experience, gift card holders have been able to redeem gift cards in full or subject to certain conditions in a number of external administrations. The external administration of Dick Smith seems to be an exception.

The proposal of placing an obligation on external administrators to honour gift cards gives rise to a number of issues, including:

- Not all external administrations continue to trade
- Not all external administrations necessarily have the financial resources to meet the balance sheet liability amount of gift cards as the company is insolvent
- Creates a priority for gift card holders over other creditors
- May create a priority over expenses an external administrator incurs depending on the actual change to the legislation
- May be a determining factor on an external administrator on whether to continue to trade or not depending on the amount of the liability
- Creates difficulties in finalising an external administration for those gift cards that have not been presented if a redemption time frame is not determined
- Whether the customer base and goodwill is strategically important in the external administrator’s realisation plan

It is our view that the status of gift card and layby holders should remain as unsecured creditors and that external administrators may exercise their discretion in honouring gift cards or continuing with layby arrangements. This will be determined by the economics and strategy of the external administrator.

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Proposal: Require funds that are used to purchase gift cards be kept in a separate trust account by businesses

This proposal is of some merit, but it may be complex and costly to implement. Issues to consider:

- Not all gift cards are redeemed, so if a trust account were to be established for funds received for gift card purchases, then the funds may be held in the trust fund in perpetuity unless there was a mechanism to release funds to the company after a certain period of time, such as after the period of validity passes. Research has produced widely varying reports of the redemption rate, with some reports suggesting that only 70% of gift cards are redeemed, whilst other research reports that 98% of gift cards are redeemed.[10]
- There will be additional administrative costs associated with establishing and administering a separate trust account. More red tape.
- This will reduce working capital available in the company.

Proposal: Directors be personally liable for the value of gift cards purchased

For the same reasons as outlined above, it is hard to argue that gift card holders or layby holders should be entitled to priority over an employee or other unsecured creditors.

Directors should not be personally liable for unredeemed gift cards or layby claims against the company, as this would place gift card holders and layby holders in a preferential position compared to employees or other unsecured creditors. Furthermore, this would negate the purpose of a limited liability company.

Yours sincerely

Mark Korda
Partner

[10] Gift cards in the Australian market: Final Report, Commonwealth Consumer Affairs Advisory Council, 6 July 2012 at page 34