Submission to Senate Economic References Committee

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

I do not wish to make submission on (a) or (b).

In relation to (c) the effect of the appointment of external administrators on secured and unsecured creditors, including employees and consumers of retail businesses, I feel the present FEG Act provides enough protection for employees and consumers do need much more attention at the present time. In relation to (d) the effect of external administration on gift card holders and those who have made deposits on goods not delivered is really a restatement of parts of (c) as the effect is on consumers who are unsecured creditors. I propose to combine my comments of these two.

There appears to be three major elements to the effect on consumers by a retailer's insolvency. These are prepayments (deposits), gift cards and loyalty schemes. In corporate insolvency there are often groups that receive an unfair outcome.[1] Consumers are not singled out for any special treatment in the *Corporations Act 2001* (Cth) and one of the substantial challenges is how to protect consumers particularly in retail insolvency.

One aspect to contemplate is whether there should be a universal new priority for consumers, adding to s556 of the *Corporations Act 2001* (Cth) that currently provides for priorities for payment to certain creditors (mainly employees) owed money by the insolvent company. [2] While these are unsecured creditors, they are given special treatment as it has been determined by the legislature that they have special needs. Consumers who have made a prepayment for goods or services including the purchase of a gift card and then find the supplier business is an insolvent company have not been considered under the legislation to require such special treatment nor has there been any requirement to hold these funds on trust. They are merely ordinary, unsecured creditors. They wait at the end of the line for return of their money, as they are unlikely to receive the goods or services from the performance of their vendor's sales and supply contract as they had planned. The gift card is

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1 See, eg, Charlotte Villiers, 'Employees as Creditors: A Challenge for Justice in Insolvency Law' (1999) 20 *Company Lawyer* 222; Roy M Goode, 'Is the Law Too Favourable to Secured Creditors?' (1983-4) 8 *Canadian Business Law Journal* 53.

For a detailed discussion on Statutory Priorities see Christopher F Symes, *Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status*, (Ashgate, London) 2008. Chapter 8 is dedicated to consumer prepayments no different to any other supply in the way it is a sale governed by a sales contract. This absence of statutory priority or trust disregards the fact that in certain industries it is common practice to pay in advance for the supply of goods or services. One of my recommendations is that it is time for these issues to be considered by a special Inquiry conducted by the Australian Law Reform Commission on all matters relevant to consumers and insolvency. The administration of gift cards is only part of a larger concern of how we are treating consumers in corporate insolvency. Some consumers participate in loyalty reward schemes and will expect to claim their entitlements from time to time. Upon the liquidation of the companies associated with these reward schemes there is a risk that these 'entitlements' will be lost.

From the outset, it is recognised there is a tendency towards reducing the number of statutory priorities.[3] However consumers deserve better treatment upon insolvency of a supplier than they presently receive and so if adding a statutory priority is not palatable then the idea of a separate trust account for consumer prepayments and gift card amounts should be considered.

A number of specific pieces of State legislation and other government-initiated regulation provide consumers with some protection for a variety of financial risks. An example of this regulation relates to pre-paid funerals.

The English case of *Re Kayford Ltd*[4] has been the exemplar case as it illustrates the problem of consumers caught up in corporate insolvency. The company, Kayford Ltd, was a mail order company that was in financial difficulties. It took moneys sent to it and held them in a special trust account. On liquidation it was held that these funds had to be returned to the consumers as the trust account did not form part of the realisable estate of the company. Justice Megarry reasoned that the consumers were 'members of the public, some of whom can ill afford to exchange their money for a claim to a dividend in the liquidation'.[5] Such considerations would not be in the judicial domain if the legislators were to add a consumer category to statutory priorities or require a trust account treatment of prepayments and gift card amounts.

3 The Cork Report in the UK in 1982 expressed the view that 'there is widespread demand for a significant reduction, and even a complete elimination, of the categories of debts which are accorded priority in an insolvency' Report of the Review Committee *Insolvency Law and Practice* Cmnd 8558 (1982) para 1397.
4 [1975] 1 WLR 279; 1 All ER 604.
5 Ibid 282.

There is no mention of consumers or consumer prepayments in the *Corporations Act 2001* (Cth). Consumers, after providing money as a prepayment for goods or services to a company which later becomes insolvent, find themselves as unsecured creditors of the company. At best, they may have other means to recover their money − such as through an insurance cover (and with gift cards purchased with a credit card there is an ability to claim which assists the consumer in an insurance-like manner) or an independent special trust fund set up to address such eventualities. As part of measures aimed at consumer protection some State governments have specific 'funds' set up to 'insure' consumers.[6] Occasionally, particular industries like the travel industry and the building industry provide similar relief.

In Australia we experienced the collapse of Ansett Airlines in 2001. The travel industry had operated for many years a form of insurance, the Travel Compensation Fund (TCF), to cover such eventualities. Upon the insolvency of Ansett this fund was accessed, along with the commercial magnanimity of the opposition carrier, Qantas, to honour tickets issued by Ansett to their customers. Recently with the collapse of Dick Smith we have witnessed Coles, Woolworths and Kogan offering 'swaps' for their own gift cards. However, consumers involved in other financial collapses like health clubs have not been so lucky. For example, in the health club industry much of the service is sold by twelve month subscriptions. This presents real problems for the consumer who is treated as an unsecured creditor if the 'club' fails. They receive no ongoing service for the money they have pre-paid. Another example was the failure of OneTel, a telecommunications company. 'Plans' are sold to users of mobile phones in this industry and some of these plans expect payment in advance. The failure of the telecommunications company will result in the service stopping and the consumers still being 'in credit'. Under Australian insolvency law, consumers having telecommunication plans are treated as unsecured creditors. Again, when OneTel failed, commercial magnanimity (or opportunism) saw other telecommunications companies such as Optus offering to pick up customers of the failed company at special deals that incorporated the 'credit'.

Another area of consumer prepayments where the insolvency of the supplier can become troublesome is Internet retailing. With the introduction of the Internet and the ever-increasing use of such means to trade, it is only a matter of time before there is a major incident of Australian consumers losing their prepayments to a failed internet retailer. Despite the fact

[6] See, eg, *Travel Agents Act 1986* (SA); *Funeral Funds Act 1979* (NSW).

that businesses that offer Internet supply will often be offshore companies, some protection for consumers through the *Corporations Act 2001* (Cth) may be possible by the requirement to appoint a local agent.[7] Certainly, the Act provides for some protection where a foreign company wishes to carry on business in Australia by facilitating the appointment of a local agent.

Insolvency legislation has not provided for special treatment of consumer prepayments throughout its long history in Australia. Consumer protection laws were substantially developed in the early 1970s as the 'untrained consumer is no match for the businessman'.[8] However, while they addressed numerous unfair trade practices, they did not extend to giving consumers special redress upon the insolvency of the suppliers of goods and services.

Submissions to the Harmer Report[9] in 1988 did not show strong support for a new consumer statutory priority for consumers in insolvency. Instead there were suggestions that consumer pre-payments should go into a separate trust fund with its own banking account.[10] This would have enabled the consumer to be paid outside of the insolvency administration and any shortfall that was unable to be met from the trust would be considered a breach of trust by the company. However, if there were few assets left then the cost of proceeding and the likelihood of an unsatisfactory return would seem to reject this alternative as viable. The Commission, in a footnote, conceded that if certain prepayments were held in trust they might be entitled to a non-statutory priority under trust law, and this would protect the interests of consumers without creating new priorities in the insolvency legislation.[11]

The Financial Counsellors Association of Victoria supported the idea of a new statutory priority and gave evidence that:

> there is a sufficiently strong case … to justify creating a new priority. The requirement for consumer prepayments often features in the most failure prone business enterprises. Our Association believes that prepayments should be protected and should not be used to finance business operating costs, etc. There have been many cases in the recent past which demonstrate the need for priority status for prepayments.[12]

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7 See, eg, *Corporations Act 2001* (Cth) s601CF. At common law the tendency is to treat the matter of statutory priorities as determined by local law. See *Re Commonwealth Agricultural Service Engineers Ltd* [1928] SASR 342.

8 Australia, Senate, *Debates* ,27 September 1973, 1013 (Senator L K Murphy QC – Attorney General).

9 Australian Law Reform Commission, *General Insolvency Inquiry* Report No 45 (1988) 'Harmer Report'.

10 Ibid, Submission no 156, Australian Institute of Credit Management, 8. Copy on file with the candidate.

11 Ibid, fn 94.

12 Ibid, Submission no 177, Financial Counsellors Association of Victoria (Inc), 8. Copy on file with the candidate.

The only other submission listed in the Harmer Report as supporting the introduction of a statutory priority was the Department for Community Welfare from South Australia, although their submission focussed on the personal insolvency of a trader and on goods that were being held in stock.[13] The submission supported the priority repayment of money paid as a deposit, progress payment or advance payment in full for goods and services, in cases where the goods have not been supplied or the services not performed.[14] The Department rejected an idea for a statutory priority of any expenses the consumer may have incurred in relation to these goods or services, such as the cost of having goods installed.[15]

Opposition to the idea of a consumer priority was mounted in a submission from Geoffrey McDonald of Love and Rodgers Chartered Accountants in the Harmer Report.[16] This submission suggested that the public had become more familiar with the law in general and, as a result, had changed their purchasing behaviour. McDonald believed there would be a change from the practice of paying a minimal deposit or paying for goods in whole subject to delivery.[17] This change would dramatically reduce the incidence of losses to consumers who had prepaid contracts.[18]

The Harmer Report decided that there was not a 'sufficient case regarding pre-paid consumer contracts to justify creating a new priority'.[19] As outlined above, the Commission received few submissions both for and against introducing a priority,[20] but refused to deviate from the 'fundamental principle of equal sharing' and their more general 'conclusion that the priority provisions should be limited rather than extended'.[21] The Harmer Report was prepared from the largest inquiry ever conducted into insolvency in Australia and these few submissions suggest it was not a major concern for most who gave evidence. The size of the problem at that time, in the late 1980s, is difficult to ascertain without empirical study. Unfortunately the

13 Ibid, Submission no 137, Department for Community Welfare (SA), 3. Copy on file with the candidate.
14 Ibid, Appendix 2. Note here they were suggesting that there be an addition to the *Bankruptcy Act*'s list of priority creditors, not change the corporate insolvency statutory treatment.
15 Ibid.
16 Ibid, Submission no 136, G McDonald, 17. Copy on file with the candidate.
17 Ibid.
18 Ibid.
19 Ibid, para 771.
20 Ibid, Submission no 138, The Joint Submission of IPAA, ICA and ASA, 19. These bodies were against this proposal. However, their submission rejects a number of other proposals and mentions consumer prepayments only once. In rejecting a number of these ideas they then sum up by stating that they support the ALRC's rejection based on the 'philosophy of a rateable distribution amongst all creditors' despite being in favour of some priorities like administrative expenses and putting liquidator's fees and remuneration first!
21 Ibid, para 771.

same could be said for the current situation as it is unlikely there is any empirical data collected on the current losses suffered by consumers in corporate insolvency. As has been called for in recent times, another ‘all embracing’ Inquiry into insolvency is long overdue in Australia.

Today, there may still be areas of consumer behaviour that would result in the consumer losing money following the insolvency of a corporate retail trader. It is difficult to generalize about the outcome of contracts that involve consumers upon the retailer’s liquidation. The appointment of a liquidator does not necessarily constitute grounds for the termination of a continuing contract or a repudiation of it. It will depend upon the nature and terms of the contract involved. If the contract continues then only a later repudiation will end it. If the appointment serves to discharge the contract then it will be by frustration or breach. For the consumer, this situation can mean that a continuing contract may be possible to complete by paying the balance owing on any lay-by and receiving the goods in question. This is done by the consumer dealing direct with the liquidator on behalf of the company. In the recent gift card insolvencies consumers have been advised by consumer groups to contact the liquidator/administrator to establish their position.

However, in a situation like a prepayment for the supply of awnings which is usual given the need to make the awnings to a precise measurement, the liquidator of such a retailer may not permit the work to be completed. Without completion the subsequent payment of the remainder of the contract amount by the consumer would not be required. However, in such circumstances the ‘deposit’ remains in the hands of the retailer and the consumer must prove for the amount as a debt, thus being treated as an unsecured creditor. No priority creditor status is given.

Due to the size and nature of the transaction, it is possible that the consumer has more chance of receiving goods and services completed after the appointment of a liquidator than if the work in progress was large and complicated and ordered by other larger corporate entities. The liquidator after appointment will try to calculate whether there is a financial benefit accruing to the retail company by completing any contracts. It is the liquidator’s decision whether to complete and if he or she chooses not to complete this may result in claims for a breach of contract. Consumers that have partly paid will join other unsecured creditors if there has not been a reciprocal part performance. As the CCH Australian Insolvency Management Practice text suggests:

> [the liquidator] would be more amenable to completing the production of partially manufactured clothing in a downtown inner city location than the completion of major earthmoving contracts spread over remote areas of the State.[22]

For a consumer who has made a prepayment the type of work needed to complete the work is likely to be small and less complex.

Some dedicated consumer protection laws do assist consumers faced with loss through an incomplete transaction by a failed retailer. The States in particular have responded by encouraging their consumer affairs departments to develop legislative and alternative resolutions responses. For example, a state consumer affairs department may try to discuss with the liquidator the options available to consumers of a particular supplier such as a retailer who has many items held on lay-by or has a large gift card regime. An example of the States assisting consumers in insolvency matters is in the area of prepayments to funeral providers who subsequently fail.

The very reason a consumer is treated as an unsecured creditor in corporate insolvency has driven States to legislate in the funeral industry. In New South Wales a *Funeral Funds Act* was enacted in 1979 and amended in 2003 by the *Funeral Funds Amendment Act*. The objects include protection of pre-payments made by consumers for funeral services[23] and this is most relevant if the contract has been made with a supplier that has now liquidated. In Queensland, the *Funeral Benefit Business Act 1982* (Qld) attempts to regulate the payments to entities in respect of prepaid funeral benefits. In Victoria, there is a *Funerals (Pre-paid Money) Act 1993* (Vic) that regulates the taking and management on money in respect of pre-paid funeral contracts. These pieces of legislation remove the prepayment from the funeral provider and require it to be invested with approved and separate trust funds that are subject to regular audit and other controls. Other States where they have no legislation on this issue rely on self-regulation of these matters by voluntary codes of conduct.

Some comparisons with other jurisdictions

[22] Taylor, Ferrier, Hodgson, *CCH Australian Insolvency Management Practice* (looseleaf, 2004) 83−240.
[23] *Funeral Funds Act 1979* (NSW) s3.

In the UK the Cork Report[24]on insolvency in 1982 chronicled payments in advance for goods and services. The Cork Committee 'received many complaints that members of the public who pay in advance for goods and services have no remedy except as unsecured creditors in the event of the insolvency of the trader'.[25] The Committee recognised the problem for consumers, stating that 'they do not see themselves treated as ordinary providers of unsecured credit, though this is how they find themselves, except in those cases where special schemes have been established for their protection'.[26] The Cork Report noted that television and radio programmes and articles in the press and other media had also expressed concern that the law was unjust to members of the public who paid in advance for goods and services.[27] The Committee heard evidence that 'a considerable number of companies, dealing direct with the public, which become insolvent, have accepted or required payment prior to the delivery of the goods and services'.[28]

Despite the profiling of this problem, the Committee refused a statutory priority treatment and specifically rejected the idea of legislation that would require all such money to be paid into special accounts having trust status.[29] In what seems a harsh treatment of consumers, the Cork Report stated;

> The customer who pays in advance for goods or services to be supplied later extends credit just as surely as the trader who supplies in advance goods or services to be paid for later. There is no essential difference. Each gives credit; and if the credit is misplaced, each should bear the loss rateably.[30]

The Cork Report noted that one of its members expressed an opinion that a purchaser of future goods 'should not be expected to provide' for the supplier 'working capital' and recommended, inter alia, that 'payments made in advance should become trust money'. This member did not go so far as to recommend a statutory priority.[31]

The Cork Report concluded this topic by suggesting that the principle of *pari passu* (equal treatment and distribution) must continue to be the 'cornerstone' of any legislation and so

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24 Review Committee *Insolvency Law and Practice* Cmnd 8558 'Cork Report' (1982).
25 Ibid. para 1048.
26 Ibid.
27 Id, para 1049.
28 Ibid.
29 Id, para 1049, 1050.
30 Id, para 1052.
31 Id, para 1053.

they were not going to advocate any qualification to this principle to deal with problems such as consumer prepayments.[32]

Just two years on from the Cork Report, in 1984 the United Kingdom's Office of Fair Trading (OFT) produced a Report on *Prepayments and Insolvency*.[33] The Report found that there was no clear cut, unambiguous solution to the problem posed by prepayments in insolvency and the authors of this Report felt the most promising course of action was to pierce the veil of limited liability for company directors.[34] [I have made comment below that I do not believe we should contemplate such move in Australia when addressing gift cards] The authors did consider granting consumer creditors a priority in insolvency and pointed to difficulties in determining the scope of such protection.[35]

In 1984, the National Federation of Consumer Groups submitted to the Minister of Consumer Affairs a report called *Prepayments (Protecting Consumers' Deposits)*.[36] They also produced a draft Consumers' Prepayment (Protection) Bill. The Bill proposed that prepayments would be impressed by a statutory trust and that the supplier be prohibited from using such prepayments as business capital or for similar purposes until the contract with the consumer was performed. The Bill also provided that the Secretary of State would have a discretion to make exceptions for areas of goods or services that had existing adequate protection. Exceptions were envisaged for the existing bonding scheme for travel agents, or insurance taken out by a supplier, or legislative protection like the Air Travel Reserve Fund, or self regulation like the Mail Order Protection Scheme.[37]

At the time the draft Bill was said to be 'worthy of consideration',[38] although it was criticised for being 'clearly insufficient' as it failed to admit exceptions for the frequent cases in which

32 Id, para 1072.
33 Anthony I Ogus and Charles K Rowley, *Prepayments and Insolvency* Office of Fair Trading Occasional Paper (1984).
34 Anthony I Ogus and Charles K Rowley, *Prepayments and Insolvency* Office of Fair Trading Occasional Paper (1984) 34.
35 Id, 24−26.
36 The National Federation of Consumer Groups submission is discussed in Editorial, 'A Consumers Prepayment (Protection) Bill?'[1984] *Journal of Business Law* 105.
37 The Bill is discussed in detail in Editorial, 'A Consumers Prepayment (Protection) Bill?'[1984] *Journal of Business Law* 105.
38 Ibid.

the supplier does not supply from stock but requires the prepayment in order to buy material needed for the execution of the contract.[39]

The OFT concluded that the time was not ripe for legislative action and did not adopt the proposals in the Bill. Again, the OFT were criticised because such legislative action, designed to protect consumers who have made a prepayment, was said to be unavoidable, as 'one day a widely publicised failure of a supplier'[40] would occur.

In the United Kingdom the issue of consumer prepayments included payments for outside painting, roller blinds, coach trips, holidays, air tickets, carpets and home improvements, with the last two being 'particularly bad' for consumers.[41] These would be similar for Australians and the travel industry here has addressed the problem in their industry. A number of methods of protection were espoused at the time and amongst these remedies were special insurance and separate trust accounts and suggestions that the prepayment creditor could be a priority creditor, even though there was a trend based on fairness principles to reduce the range of priority creditors.[42]

The UK academic, Vanessa Finch, has canvassed the issues for consumer prepayers in the United Kingdom.[43] She suggests that they may be geographically dispersed and this weakens their position. For example, they may not be where they can access information about the retailer, to be able to assess risks and be warned against failure. She also makes the observation that 'consumer creditors may fail to see themselves as creditors at all'[44] – especially, she says, where the retailer leads the consumer to think the period of prepayment is short. The *Insolvency Act 1985* (UK) and the *Enterprise Act 2002* (UK) that address other statutory priorities remain silent on a consumer priority.

In the US there is a legislative provision that is designed to give limited protection to consumers in their dealings with retail merchants and these are usually deposits on

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39 Editorial, 'A Consumers' Prepayment (Protection) Bill?' [1984] *Journal of Business Law* 106.
40 Editorial, 'Protection of Consumers' Prepayments' [1985] *Journal of Business Law* 12. The editorial concludes 'why not shut the stable door before the horse has bolted?'
41 Alec Samuels, 'Prepayments: The Lost Consumer Deposits' [1987] *Journal of Business Law* 30.
42 Id, 31.
43 Vanessa Finch, *Corporate Insolvency Law Perspectives and Principles* (2002) 429–431.
44 Id, 430.

merchandise that is undelivered by insolvent retailers.[45] The subsection has been described as unambiguous and clear and the courts accord no weight to its legislative history.[46] The use of the term 'deposit' in the subsection is to provide a remedy for pre-purchase defaults by debtors in consumer transactions only and the appropriate definition of 'deposit' is 'putting down as pledge or partial payment'.[47]

In Canada there was a suggestion for including a consumer statutory priority in insolvency legislation by the Law Reform Commission of British Columbia.[48] In 1987, the Commission discussed strategies for reform in the area of consumer prepayments and they considered recommending a statutory priority in the insolvency statute. The Commission believed that the consumer's position was 'very precarious', yet conceded that there was no way they could be fully protected from losses when a retail seller, because of insolvency, failed to deliver goods.[49] The Commission looked for ways to improve the legal position of consumers to reduce the likelihood of loss and recommended the creation of a buyers' lien.[50] They commented that a statutory priority was the most direct way of achieving an enhanced legal position for consumers and had the advantage of simplicity.[51]

Ultimately, however, the Commission in British Columbia rejected the idea of a consumer priority in the insolvency statute as an appropriate vehicle of reform, in part because the reforms had not 'evinced any concern with consumer buyers' and the tendency for insolvency reform was towards decreasing the number and classes of priority creditors rather than increasing them.[52]

In NZ in 1999, the New Zealand Law Commission's Advisory Report to the Ministry of Commerce on priority debts,[53] mentions the *Lay-by Sales Act 1971*. This Act provided in

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45 *In re Cimaglia* (1985, BC SD Fla) 50 BR 9 although other cases have dealt with services such as tuition funds in *In re Longo* (1992, BC DC Md) 144 BR 305, 5 Fourth Cir & Dist Col Bankr Ct Rep 36.

46 *United States Code Service* (2003) Annotations to § 507 under the heading 'History, Ancillary Laws and Directives', 63.

47 Ibid, *In re Heritage Village Church & Missionary Fellowship* (1991, BC DC SC) 137 BR 888, 4 Fourth Cir & Dist Col Bankr Ct Rep 531, 26 CBC2d 1093.

48 Law Reform Commission of British Columbia, *Report on the Buyers Lien: A New Consumer Remedy,* Report No LRC 93 (1987).

49 Id, 4.

50 Ibid.

51 Id, 15.

52 Ibid.

53 New Zealand Law Commission Advisory Report to the Ministry of Commerce, *Priority Debts in the Distribution of Insolvent Estates* (1999).

s11(1) that where there was a liquidation of a seller and there were no goods or not enough goods to enable the lay-by sale to be completed, the buyer would become a priority creditor in the liquidation. The extent of the priority was the amount of payments that the buyer had made in the course of the lay-by. The Commission noted that where a company failed and there were goods the subject of a lay-by contract, these customers often sustained heavy losses.[54] Under s10(1) of the *Lay-by Sales Act 1971* if, on liquidation of the seller, the seller had goods of the kind which they had agreed to sell, whether those goods had been appropriated to the sale or not, then the buyer might pay the balance of the purchase price and obtain those goods. Such treatment alleviated the need for any sort of priority.

The Commission noted that an earlier committee - the Contracts and Commercial Law Reform Committee of New Zealand in 1969 on ‘Lay-by Sales’ − had stated that lay-by customers were a special class of creditors in the insolvency of the lay-by vendor.[55] This committee had expressed the view that if a priority were given it would see financiers and merchants exercising a degree of supervision over lay-by vendors and the unstable lay-by vendor would find it more difficult to raise finance or obtain credit.[56]

The New Zealand Law Commission, looking at the situation 30 years after the Contracts and Commercial Law Reform Committee of New Zealand and with 28 years of legislative experience from the *Lay-by Sales Act 1971* (NZ), stated that there were compelling reasons why the priority afforded by the Act should be continued.[57]

The Commission in New Zealand stated four reasons for keeping the priority. Firstly, they said prudent budgeting should be encouraged by the law and anecdotal evidence suggested that lay-by was still a popular form of purchasing goods despite the growth in the use of credit cards.[58] (This is an interesting difference to Australia, where the Rogerson Report in 1969 stated that the use of lay-by was not widespread and appeared to be declining even back then.[59]) Secondly, they recognised that those who use lay-by systems are often consumers of

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54 Id, para 173.
55 Id, para 173 citing The Contracts and Commercial Law Reform Committee of New Zealand, Lay-by Sales (1969) 9.
56 Ibid.
57 Id, para 175, 176.
58 Id, para 175.
59 *Report to the Standing Committee of State and Commonwealth Attorneys General on the Law Relating to Consumer Credit and Money Lending*, The Law School University of Adelaide (1969)(known as the Rogerson Report). See, particularly chapter titled ‘Miscellaneous’.

'modest means' who can ill afford to lose the money.[60] Thirdly, they felt that the sums involved were 'generally modest and are unlikely to impact on dividends received by other creditors'.[61] Finally, they noted that the appropriation of goods by the vendor was typically beyond the control of the customer.[62]

The special nature of consumers

It has been argued that the prepayment consumer creditor is not just another creditor, as their claims are different to those of other creditors. One commentator describes the prepayment consumer creditor as

> a layman (sic), ignorant of the law and commercial practice, with no access to information regarding creditworthiness, risking his money and not appreciating the risk ... the consumer is likely to be a small man, making a not insignificant prepayment.[63]

It was argued in 1987 that it is not right to expect the prepayment consumer to compete with public and trade creditors in a winding up.[64] This is because trade creditors can look after themselves and the debt is not likely to be personally distressing. The consumer prepayments creditor is not really a creditor, in the commercial sense, but more like a beneficiary of a trust and therefore deserving of some sort of special protection or priority.[65]

Arguments used for protecting other priority creditors like employees often criticise the company's practice of using the money for such employee entitlements as emergency working capital. These same arguments apply to consumer prepayments and the money taken from sales of gift cards. Such behaviour has been considered 'morally wrong' and an 'improper business practice'.[66]

A statutory priority in the insolvency statute for consumer prepayments would be simple and overcome difficulties such as the need to keep a trust account and other record keeping. The options of establishing a trust for the prepayments or creating a statutory priority would be equally efficient and not impact greatly on post- insolvency expenses.

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60 New Zealand Law Commission Advisory Report to the Ministry of Commerce, *Priority Debts in the Distribution of Insolvent Estates* (1999).
61 Ibid.
62 Ibid.
63 Alec Samuels, 'Prepayments: The Lost Consumer Deposits' [1987] *Journal of Business Law* 30, 32.
64 Ibid.
65 Ibid.
66 Id, 32, 33.

While every consumer prepayment needs the protection, only the unfulfilled ones need a mechanism for repayment. The statutory priority option is not an imposition on all solvent companies and this is important because not all fail or engage in business practices that use prepayments for emergency working capital.

I believe there are four justifications for introducing a statutory priority or a trust for consumers in insolvency.

1 – ability to gain and use information concerning default risk

Consumers have little ability to gain information about the risk they are taking with any company that requires a prepayment. Apart from requesting financial statements or credit checking, which is unlikely for consumers, there is not an easy way to facilitate the access to information. Large numbers of proprietary companies are relieved from depositing an annual return with meaningful financial information to the government regulator, ASIC. Minor protection would be available from government consumer affairs departments, who can give general advice but they would not advise on the financial standing of particular retail companies. Freedom of contract principles though might suggest that consumers are always free not to contract where the prepayment aspects of the retail trade cause concern.

2 – capacity to exit from excessively risk-laden arrangements

The consumer may be able to exit from a retailer's contract with prepayments, but it may constitute a breach of contract. Contract law would probably determine that the contract is voidable if the consumer has already paid their prepayments. For the consumer the option of exit from the contract has probably expired once a liquidator is in place. The best the consumer can hope for is the completion of the contract by the liquidator. The consumer is a voluntary but unfortunate creditor.

3 – vulnerability to risks

The size of the consumer's exposure obviously varies throughout the different industries that require prepayments. For some work there is an industry standard that half the amount of the transaction will be paid in a prepayment, whereas other industries might work on just 10% being forwarded before work will commence. In the gift card transaction the vulnerability is the amount paid for the gift card. While amounts might be small like $50 there is anecdotal evidence of consumers buying multiple gift cards as Christmas presents to give to numerous family members and friends hence bearing the risk of the combined amount. The amount of risk for the consumer to bear is therefore different depending upon the transaction and industry. Because of the lack of uniformity across jurisdictions in Australia with regard to some industry safeguards, the vulnerability will also differ depending upon the State the consumer resides in. Furthermore, the incidence of insolvency is greater in some industries that require prepayments as an industry norm, than others. This is highlighted by the fact that some States have chosen to legislate to give specific protection while others States show much less interest. An insolvency practitioner may seek to complete the contracts and then the consumer achieves a satisfactory outcome, but then other liquidators given the particular company's circumstances may choose not to go to such lengths.

The consumer will be vulnerable to risks that they do not understand or are even aware of, as they make their prepayment or buy their gift card after being exposed to the marketing and information asymmetry of the retailer. This is particularly likely where they are told that this is the way the retailer, and all others in that particular industry, do business.

4 – status as a low- or high-cost bearer of risk

Consumer prepayments are not going to be present in all insolvencies and consumers come in all shapes and sizes, from the very wealthy to the very poor. When a consumer prepayment is lost or a gift card is not honoured through corporate insolvency, the risk is essentially borne by the individual consumers. Individually, they become a low cost bearer of risk because they will generally have other financial means, independent of this contract, and this may be the only contract that they have entered and for which they have not received satisfactory performance. They still hope for reimbursement but for them to fail to receive anything from this contract, and its prepayment, is unlikely to be critical to their financial position. Despite the fact that the consumer might be in the position to bear of loss of say $1,000 for awnings that they never receive due to a supplier's liquidation or the failure to have ten gift cards of $50 honoured, it is undesirable for consumers to be burdened with a position of a low cost bearer of risk. The consumer who may be a pensioner who has had to save up to order those awnings or who has purchased ten $50 gift cards for each of their grandchildren as Christmas presents, bears what they perceive as a high cost if they lose the prepayments and receive no awnings or their grandchildren receive no present. They have to start saving all over again and so currently they bear the risk.

The collection of empirical data would assist to justify the introduction of a new statutory priority or trust.

If consumers were to be given a priority in the *Corporations Act 2001* (Cth), a new subsection could be added to s556(1) that read:

> next, if at commencement date there were amounts due in the nature of consumer prepayments such as lay-bys, advance payments or deposits and there has been no performance of the related contract, these amounts.

If such a measure were to eventuate and a consumer priority was added to the *Corporations Act 2001* (Cth) s556(1) it would surely hold a position after the existing priorities of administrative expenses and employee entitlements.

Loyalty Schemes

Related to the topic of consumers and corporate insolvency involving prepayments and gift cards are the relatively new phenomena of loyalty points, reward schemes and frequent flyers. It is arguable that consumers need some assistance in this area.

Frequent flyer and other such schemes attempt to reward customer loyalty. In effect a consumer is rewarded in points that can be redeemed for goods and services, mainly airline flights, by maintaining loyalty to a particular supplier including retailers. Most programmes have rigid terms and conditions which protect the supplier. The method and /or time of taking up or spending frequent flyer/ reward points are subject to the supplier's terms and conditions. Frequent flyer points have been described as 'incapable of being accurately valued and even if this were not so, the supplier's terms and conditions prohibit this conversion'.[67] Recently, there has been trading in points and while the possibility of purchasing points from other consumers has been discouraged, some suppliers have commenced selling points that are not earned through purchases. For most consumers the frequent flyer points bestow an entitlement to certain rewards at the sole discretion of the supplier and cannot be transferred from one supplier to another and cannot be redeemed for cash. This makes them unique if the supplier who may be a retailer is liquidated.

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[67] J Farey, Member, Consumer, Trader and Tenancy Tribunal (NSW) in *Ling v American Express International* [2003] NSWCTTT 249 (10 March 2003).

From a legal point of view frequent flyer schemes have created some interesting law. In Australia, there has been litigation on the question of whether they are assessable under the *Income Tax Assessment Act 1936* (Cth) as 'income' or a 'benefit'.[68] The Federal Court has held they were not income for such purposes and, upon the facts before the Court, they were not a 'benefit' as the employer did not know that the employee was receiving the benefit.[69] In Australia, there have been other cases involving their treatment in matrimonial property settlements, their inclusion in the definition of 'remuneration' under industrial law[70] and trade practices disputes (predominantly misleading and deceptive conduct claims) over the transfer of points[71] and the unavailability of the points for a consumer in the United States of America due to Ansett's collapse.[72]

With the failure of Ansett in 2001, there was an enormous amount of public discussion in Australia regarding the fate of loyalty 'credits' that were earned by consumers (customers) of the airline. With Ansett's liquidation in 2002 the 'credits' entitling free flights or upgrades were lost. The topic is of some legal interest because frequent flyer points are not purchased but given as a reward for choosing this particular retailer. The recipients of these entitlements are not really 'creditors' as they have no debt owed to them.

The Ansett airline failure shows just how such schemes can impact in insolvency. Ansett had 2.7 million frequent flyer 'members' who had accumulated unused frequent flyer points.[73] When the insolvency administrators were working upon the Part 5.3A procedures (Australia's corporate rescue legislation) and attempting to put together a rescue package they included the frequent flyers in their deliberations. The administrators were required to hold the second statutory meeting (the meeting that determines the future of the company) and so notice of this meeting had to go to 'as many of the creditors of the company as is reasonably practicable'.[74] Notice was required to be given by delivering it personally or

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68 *J L Payne v Commissioner of Taxation* Nos NG 461 of 1995 and NG 239 of 1995 Fed No 347/96, 94 ATC 4191.

69 Ibid, 4193.

70 *Jackson and National Aboriginal Islander Skills Development Association Inc* NSWIRComm 118 (24 April 2003).

71 *Ling v American Express International* [2003] NSWCTTT 249 (10 March 2003).

72 *Zilka v Westpac Banking Corporation* [2002] NSWCTTT 527 (20 September 2002).

73 *Business Review Weekly* reported in October 2001 that 'more than four million Ansett Global Rewards members have probably lost all their points' and they also said that 'Ansett customers are furious that their points are now worthless.' Emily Ross, 'Flyblown Rewards' 23(5) *Business Review Weekly* October 4-10 2001, 34.

74 *Corporations Act 2001* (Cth) s439A(3).

by sending it prepaid post or fax or DX.[75] Compliance with these provisions posed administrative difficulties and considerable expense for the administrators. Ansett's financial position involved assets of $850 million and liabilities of $1.8 billion-2.0 billion.[76] The cost of sending this notice and the required documentation to creditors was estimated at $28 million.[77] Even if the administrators sent a one-page double-sided notice it would still cost nearly $1.3 million.[78] The administrators sought the Federal Court's directions. Options were given to the Federal Court such as only giving 'proper' notice to unsecured trade creditors (who had a greater right to notice) and then giving notice by way of the internet and newspaper advertisements to frequent flyers.[79]

The situation posed the question of frequent flyer points holders as creditors in the insolvency. Justice Goldberg determined that

> [A]lthough there is an issue for the administrators to resolve in relation to the value to be given to the rights of the holders of frequent flyer points as creditors, I do not regard that as a relevant consideration to take into account in determining the manner in which notice of the second meeting should be given to creditors. Nor do I regard the manner in which the holders of frequent flyer points acquired their points, or can use them, as a relevant consideration on this application. Once the administrators make the decision (as they have done) to treat the holders of frequent flyer points as creditors for the purpose of the second meeting, those holders are to be treated in the same way as other creditors in relation to the manner in which they are to be given notice of the second meeting.[80]

So without giving real direction of whether frequent flyers were creditors for insolvency purposes, Goldberg J treated them in that vein because the administrators had already done so. It was resolved that newspaper advertisements and the internet web page could be used to satisfy the notice provisions in question.

Now consider a retailer entering insolvency and having a loyalty scheme with attached benefits. The same issues could arise that were dealt with by frequent flyer rewards in Ansett.

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75 *Corporations Regulations* 5.6.12(2).

76 In a book on the fall of Ansett, *Ansett the Collapse* (2002) the authors Geoff Eastdown and Peter Wilms have included an appendix listing Ansett's major creditors as at 4 March 2002. The first entry reads 'Golden Wings members, trade suppliers, frequent flyer points holders and coupon creditors 1.1bAustralian dollars.'

77 Leon Zwier, Dany Merkel and Ian Buchanan, 'Ansett Administration Court-Approved Websites' (2002) 76(3) *Law Institute Journal* 46, 49.

78 Ibid.

79 *In the matter of Ansett Australia Limited and Mentha* [2002] FCA 2 (7 January 2002).

80 *In the matter of Ansett Australia Limited and Mentha* [2002] FCA 2 (7 January 2002) 9.

There is a threshold issue of whether frequent flyers/loyalty members really are creditors.[81] If they are creditors, then their need for a statutory priority or other special treatment can be explored. Firstly, the difficulty in valuing frequent flyer points/loyalty rewards is acknowledged. Courts have decided that the frequent flyer membership is a contract and the use of the points results from a personal contractual entitlement with the individual who earned them.[82] Such considerations are likely to feature in future litigation.

Many present marketing strategies encompass loyalty schemes, some that involve large retailers (e.g. Flybuys at Target), large banks (e.g. at Citibank) and tourism operators, and this way of doing business is likely to continue.
Failure of the retailer that offers such schemes may occur and it would have a large impact on the community who lost these 'rewards'.

Legislation could clarify the position of frequent flyer and loyalty schemes in insolvency and points-holders as creditors.[83] At present upon liquidation all loyalty scheme participants lose their points. Information is crucial for the protection of consumers[84] and the lack of information on frequent flyer schemes for consumers has been criticised.[85]

As to (e) of the Inquiry I submit as follows:

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81 See Christopher Symes, 'Lessons on Loyalty Schemes in Insolvency' (2003) 4 (3) *Insolvency Law Bulletin* 33.

82 *Payne v Commissioner of Taxation* Nos NG 461 of 1995 and NG 239 of 1995 Fed No 347/96.

83 It is possible that this interpretation by the Federal Court in *Ansett* as reported above could be tested in the future.

84 The website **www.frequent.flyer.com.au** assisted consumers during the Ansett downfall. They reported that Ansett Global Reward members (the frequent flyer scheme) were being discouraged from registering as creditors. They encouraged members to register and ignore the consultant on the Ansett help line who would 'probably tell you that you cannot register.' The advice was to request a proof of debt form, complete it and lodge it as soon as possible.

85 For example, in Canada, *Democracy Watch* said 'With airlines offering an increasingly broad array of inter-airline partnership and frequent flyer deals, consumers often lack the information needed to take advantage of these deals … consumers are largely unorganized … and … few consumer groups exist to represent the consumer interest and provide information to consumers'. Democracy Watch, 'Creation of Watchdog Groups to Monitor Canadian Banks, Cable TV and Telephone Companies, and Airlines', Democracy Watch On-line 26 August 2003, www.dwatch.ca/camp/actcub.htm.

(i) **The desirability of placing an obligation on external administrators to honour gift cards.**

To place an obligation of external administrators to honour gift cards would be quite unusual. The obligation could take the form of a statutory priority added to the existing priorities (as suggested above). I don't see specific new provisions being drafted in Chapter 5 of the Corporations Act to place a separate obligation on the liquidator outside of the obligation they already have to comply with statutory priorities in s556. Effectively unless there was a trust account kept by every company that operated a gift cards the external administrator should only be required to find the funds to honour gift cards subject to the existing priorities.

(ii) **The desirability of a requirement that funds used to purchase gift cards be kept in a separate trust account by businesses.**

The idea of funds being placed in a separate trust account would be a cost on all companies not just those who then find themselves insolvent. At present there are no similar arrangements placed upon all companies even though something like the provisions for annual leave [which should be available as employees are owed this entitlement whether or not the company is in liquidation] and such a provision would be given some recognition in the company's financial statements. If such a requirement was placed on all companies then it need to be subject to audit comment.

(iii) **The desirability of directors being made personally liable for the value of gift cards purchased in the event that gift card holders are unable to redeem their gift cards following the appointment of external administrators.**

It is not desirable to extend directors liability to this extent. Over the years there has been concern made of imposing too much liability on directors as this may result in less people agreeing to be directors. Whilst this is hard to measure the government should implement other recent initiatives such as a Director Identification Number rather than piercing the corporate veil for unredeemable gift cards. Directors of companies that fall into insolvency and fail to honour the gift card holders are unlikely to have 'engineered' this as a fraud. Making directors liable is appropriate for the existing range of directors' duties arising from the statute or the common law but extending these duties to gift card liability is a 'bridge too far'. At present with insolvent trading laws being commented on as some of the harshest in the world do we really want to add to the existing director liabilities? There has been observations that there are few cases on insolvent trading although this should be tempered by the fact that perhaps the law in this area works as a deterrent. In any event gift card holders are likely to be in the position of creditors and so they are presently owed a duty by the directors not to permit their company to trade (which would include selling gift cards). This, then would come down to a matter of enforcement. The present law permits the liquidator or a creditor with permission to take action against directors for insolvent trading.

Perhaps if there was a strong interest in directors being penalised for such occurrences as unredeemable gift cards there could be requirement for a liquidator to report this as one matter in their s533 Report to ASIC. If a director was found by ASIC upon receiving this s533 Report to have repeatedly failed creditors who hold unredeemable gift cards then this could be a matter considered in the disqualification of directors by ASIC under s206F of the Corporations Act.

Thank you for the opportunity to make this submission. My recommendations would be

1) An Inquiry conducted by the ALRC on all consumer and insolvency issues
2) ASIC initiated empirical research to establish the extent of the problem
3) Amendment to the Corporations Act statutory priorities provision to take account of consumer issues.

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