Can I Have My Deposit Back Please?

KEY POINTS

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● The law as it presently stands can be used to ensure that directors do not use consumer pre-payments to fund insolvent trading, although it could be improved by giving express preferential status to consumers or by requiring pre-payments to be held in a trust.

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● The justification relied upon in the Cork Report (and referred to in Re Uno) for not affording preferential status in an insolvency to consumers who have lost pre-payments can no longer be maintained.

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INTRODUCTION

On 23 July 2014, the Law Commission launched its 12th Programme of Law Reform. One project selected for inclusion in the programme is “Protecting consumer prepayments on retailer insolvency — a scoping review to assess the scale of the problem and consider ways to increase protection for consumers” (the project).

“Protection” can be provided in a number of ways, namely:

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1. the setting of standards of conduct for directors as to the circumstances in which it is permissible to place consumer pre-payments at risk of insolvency;

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2. methods of effective redress (both in terms of recovery of losses and sanction of conduct) against those directors who fail to comply with such standards;

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3. the mechanisms that can be put in place within the insolvency regimes to provide recompense for the consumer in the event that the company to whom a pre-payment was made, becomes insolvent.

The primary focus of this article is, with reference to (1) and (2) above, the law as it presently stands and the “missed opportunity” in the directors' disqualification proceedings, which arose out of the demise of Uno Plc and World of Leather Plc (see Re Uno Plc [2004] EWHC 933 (Ch); [2006] BCC 725) to provide protection for consumer pre-payments.

THE BACKGROUND

The background to the project is provided by the Consumer Focus report "Pay now, pay later — consumer prepayments and how to protect them" (the report).

The following points are made in the report:

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● Prepayments are defined by the Office of Fair Trading as "any advance payment made by a consumer to a trader for goods and services which are not to be supplied immediately".

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● It is common (especially with the increase in ecommerce transactions) for a consumer to make pre-payments — examples are purchases of items of furniture, holiday bookings, payments to builders.

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● Pre-payments are attractive to businesses as they provide funds with which to meet costs that they will need to meet in connection with the particular order, provide protection against the customer defaulting on payment and are a cheap source of working capital compared to equity and debt.

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● Pre-payments are attractive to consumers as they enable the consumer to spread the cost of purchase over a period of time and it is a means of reserving "high-demand" items. Pre-payments also allow the business to keep costs down (eg, through not having to hold a quantity of stock at any given time), which means lower prices can be offered to the consumer.

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● The problem is that if the business fails then, unless consumers have paid by credit card (and therefore in transactions of £100+ are protected by the Consumer Credit Act s 75 regime) or there is an industry "ring-fencing"/ insurance arrangement in place, the consumer will not receive the goods or services that have been ordered and will rank as an unsecured creditor in the liquidation for the pre-payment with little or no prospect of receiving any repayment.

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● When making a pre-payment, the consumer often unknowingly takes on this risk.

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● The consequences of the loss of prepayments to consumers are potentially devastating, placing an immense strain on already strained finances. In short, those who lose out are those who can ill-afford to lose out.

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● This is no better evidenced than by the collapse of the Christmas hamper firm, Farepak in 2005, which took down with it approximately £38m of savings of the most financially vulnerable members of society.

A key issue for the project will be a consideration of the circumstances (if any) when it should be permissible for a business to use pre-payments as “a cheap source of working capital”, as opposed to equity or debt funding; in particular, should it be permissible for a business to use such working capital when its financial position is such that it is unable to obtain equity or debt-funding?

RE UNO

Proceedings were brought, pursuant to s 6 of the Company Directors Disqualification Act 1986 (CDDA 1986), against the former directors of Uno Plc and World of Leather Plc (the companies) following the placing of the companies into administration.

The companies operated in the retail furniture trade. They did not, however, manufacture or hold a stock of the furniture that they offered for sale. When a customer placed an order for an item of furniture, they would pay a deposit. The deposit(s) were not segregated from other revenues of

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the companies. The ordered furniture would be delivered a few weeks after the placing of the order.

The financial position of the companies deteriorated, such that they became insolvent. There was, however, a realistic prospect of the companies achieving a corporate solution that would enable them to avoid an insolvent liquidation. The directors pursued the available corporate solutions. However, while this was happening, the companies continued to trade, to accept deposits from customers and (importantly) to use those deposits as working capital.

A corporate solution was not found, so consequently the companies were placed into administration. A substantial number of consumers who had paid deposits for furniture did not receive the furniture and did not receive the return of their deposits, the unsecured creditors of the companies receiving nothing from the liquidation.

The allegation against the directors was that:

“In the period 8 November 1999 until 7 March 2000, the defendants caused or allowed WOL and Uno to trade at the risk of cash paying customers, without taking adequate or sufficient steps to ensure that, in the event that the companies were unable to find a buyer or obtain re-finance, cash paying customers would receive the goods ordered or a full refund.”

The key factors in the case (for the purpose of this article) were as follows:

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● There was a reasonable prospect of the companies avoiding an insolvent liquidation through a corporate solution.

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● There was equally a real risk that a corporate solution would not be found and the companies would enter an insolvent liquidation.

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● The companies could only continue to trade while pursuing the corporate solution if it was able to continue accepting pre-payments from customers and using the same as working capital.

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● Unlike trade financiers (including banks etc), customers making pre-payments were unaware of the financial position of the companies.

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● If they had been made aware, then it was obvious that they would not have risked their money.

The court (Blackburne J) dismissed the allegation and in doing so held:

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● Following Secretary of State for Trade & Industry v Creegan [2004] BCC 835 (C/A), ordinarily a director would not be at risk of a finding of unfitness under CDDA 1986, where he caused/ allowed a company to trade while insolvent, if there was a reasonable prospect of the company avoiding an insolvent liquidation.

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● The fact that the companies were only able to continue to trade through the use of deposits paid by consumers as working capital (in circumstances where the consumers did not know of the financial position of the companies and had no choice whether or not to provide the working capital, unlike (for example) trade creditors and finance providers), was not a factor which “aggravated” the insolvent trading such as to warrant a finding of unfitness under CDDA 1986.

THE CONSEQUENCES OF RE UNO

The consequence of this decision is that it is acceptable for the directors of a limited company that is in financial difficulties, to pursue a solution to these difficulties (provided that it has realistic prospects of being brought to fruition), while continuing to trade using consumer deposits as working capital. This is despite the fact(s) that these consumers (unlike trade finance providers) are not in a position to: (a) inform themselves as to the financial position of the company and the risks they are taking; and/or (b) negotiate terms to reflect/protect against the risk and simply have no choice whether or not to provide the working capital. That is not an acceptable position.

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● There is no justification (legally or commercially) for a company in such circumstances to derive its working capital from those who are “ignorant” as to its financial position, especially when those who are informed as to its financial position are not willing to provide the same. That is conduct that takes advantage of the "ignorance" of a particular body of creditors.

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● Further, it does not produce a fair balance between the interests of the business and the interests of the creditors; nor is it fulfilling the objective of ensuring that companies conduct their trading operations with adequate (and proper) sources of capital. In this regard, the decision was contrary to the principles identified in the Cork Report on Insolvency Law and Practice Cmnd 8558 (referred to in Re Uno at [128]) at paras [216] and [1785]).

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● The court — despite referring to Creegan — failed to consider whether the fact of the reasonable prospect of avoiding an insolvent liquidation was a complete defence to the allegation of unfitness, despite the unacceptable position referred to above.

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● If this consideration had been undertaken then it is difficult to see how the prospects of avoiding an insolvent liquidation justified the consumers being placed in the position that they were, namely involuntary financiers of the attempts by the company to avoid an insolvent liquidation.

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● The judgment does not provide any reason as to why it was appropriate for the directors to decide to take risks with a consumer's money in circumstances where that customer had not consented to that risk.

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If there was a reasonable prospect of avoiding an insolvent liquidation, but that prospect could only be pursued using pre-payments as working capital, then it should not have been pursued. If those who were informed as to the financial position of the companies would not fund the "pursuit", then there was no good reason to justify the funding of it by the most vulnerable creditors.

For these reasons, it is suggested that if this issue came to be considered in the future (in particular, by a higher court), there must be real doubt whether Re Uno would be followed and if there is to be a move to improve the protection of consumer prepayments then it should not be a "missed opportunity".

DEVELOPMENTS SINCE RE UNO

Since the judgment, the Companies Act 2006 (CA 2006) has been introduced and with it the statutory duties laid down by Ch 2, ss 171–177.

Section 172 imposes a duty on a director to act in good faith in a way he considers most likely to promote the success of the company. In considering how to act, the director is required to have regard to the matters listed in (1)(a)-(f) which include:

“(c) the need to foster the company's business relationships with suppliers, customers and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of business conduct.”

The intent behind the same is to require directors to (among other things) consider the consequences of their actions on those that they are dealing with.

A director, who is now faced with the decision that the directors of Uno and WOL were faced with, would have to act in accordance with s 172. There is clearly scope to argue that a director who properly had regard to the factors listed in (1)(c)–(e) ought to conclude (for the reasons referred to above) that it would not be promoting the success of the company to pursue a solution to the insolvency position of the company using consumer pre-payments as working capital. Alternatively, the argument could be advanced that, pursuant to s 172(3), the financial position of the company should mean that steps to save the company (ie, promoting its success) should be subordinated to the interests of creditors and therefore the pursuit of a solution using consumer pre-payments as working capital could not be justified.

Such a breach of CA 2006 provisions would afford the officeholder of the insolvent company a claim against the offending director and would support an allegation of unfitness under CDDA 1986.

POSSIBLE SOLUTIONS

Trust account

The solution that is always raised is that of requiring any business that receives consumer pre-payments to hold the same within a “trust” account, separate from the working capital of the company. The company would only be able to use such funds:

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i. to meet the costs of the transaction in respect of which it was paid; and

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ii. if released on completion of the transaction.

While issues of “mechanics” as to how and in what circumstances such a solution is to be implemented and enforced will be raised, as a matter of principle there can be no objection to this solution. It is in accordance with the requirement that companies should be adequately capitalised (see above) and therefore ought to have no need to resort to use such funds as capital. Further, and most importantly, it fulfils the objective expectation and understanding of the consumer when the pre-payment is made. The consumer is expecting that the pre-payment will be put towards the costs of the transaction or held as a commitment, pending completion of the transaction. It is not expecting or agreeing to the same being used to meet the day-to-day working capital requirements of the company.

Preferential status

If the Re Uno judgment is followed, then it is difficult to see on what basis the refusal of preferential status to such consumer creditors (see Cork Report at [1414] and [1445]) can be maintained.

If the directors of a company are to be able to "back" their belief (ie, that a corporate solution can be found to the company's financial position) using consumer deposits, then there needs to be some benefit/protection afforded to the consumer to address the unsatisfactory position they will find themselves in if the belief is not fulfilled. The appropriate way to achieve this is to confer by statute preferential status on consumers who have paid deposits within a certain period prior to the administration/winding up, save where the pre-paid funds have been preserved by the company (ie, held in a separate account and not used as the working capital of the company).

This would mean that such consumers (alongside other preferential creditors) would be paid in priority to other unsecured creditors, although after any sums due to fixed charge holders or in respect of expenses incurred in the course of an administration.

The conferring of such status can be justified because the consumer is not only an involuntary creditor, it has (without its knowledge) become a creditor for the benefit of the company (including all its creditors) in circumstances where the company is unable to, or does not want to, deal with trade finance providers or introduce funds from its own resources.

As things presently stand, the consumer is the person who is ranked at the bottom, yet is the person who is least able to take steps to protect its position. The re-ordering of the priorities within the insolvency estate in the manner advocated will protect those who are least able to protect themselves from the consequences of insolvency.

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Further reading

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- Gift vouchers in insolvency: is it time for consumer protection? [2013] 2 CRI 72.

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- Trust accounts: trading in the twilight zone [2007] 23 IL and P 112.

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