Vulnerable Consumers in Retailer Insolvencies

Recent years have seen a rise in retailer insolvencies. More often than not, consumers, who make “prepayments” to businesses, may find that they are left with neither the item/service they paid for, nor any real prospect of a refund, when those businesses go into liquidation. For example, in the collapse of the home appliances chain, DSC 德爾斯, many were stunned to find that they were left without both money and furniture. The recent close down of the California Fitness gym chain has once again brought the issue into public focus. It is estimated that approximately 64,000 members are affected by the close down. Their disappointment and frustration are certainly understandable.

Apparently, Hong Kong is not the only jurisdiction troubled by retailer insolvencies. On 13 July 2016, the English Law Commission published a report on “Consumer Prepayments on Retailer Insolvency” (the “Report”), which examines the protections given to consumer prepayments in detail and considers whether such protections should be strengthened. The Law Commission concludes that providing mandatory protection for small losses would be costly and disproportionate, but recommends, among other things, a limited change to the insolvency hierarchy to give a preference to the most vulnerable category of prepaying consumers.

Proposals for Reform in the UK

When a company goes into liquidation, the liquidator must distribute the remaining assets of the company to creditors in accordance with a strict statutory hierarchy. Consumers, alongside many others, including suppliers, landlords and utility companies, are unsecured creditors. Most of the money will go to secured lenders and preferred creditors, such as employees, leaving very little, often negligible to unsecured creditors.

The Law Commission recognizes that consumers usually do not understand why the goods they have already paid for do not belong to them and can even be resold by the liquidators. The Report identifies several reasons why the protections offered to consumers should be re-examined with a view to enhancing them. First of all, it is suggested that consumer prepayments bring new money into the business. However, unlike other lenders, consumers are particularly ill-equipped to understand or assess the risks associated with making a prepayment to a retailer. Consumers also struggle to understand how they can be totally unprotected when the businesses go into liquidation. Further, the retail economy depends on
consumer confidence, which could be dented by even a handful of retailer insolvencies if major consumer losses are sustained.

On the other hand, many insolvency practitioners argue that in retailer insolvencies, losses suffered by consumers tend to be moderate rather than severe. Other unsecured creditors, such as individual contractors or small suppliers, may suffer much greater hardship in comparison. In addition, protecting consumers may deprive businesses of much needed working capital, make lending more risky or may add overheads to the businesses which are then passed on to consumers through price rises.

After a detailed examination of the protections which are available to consumers, the Law Commission is satisfied that payments by card are sufficiently protected either under section 75 of the Consumer Credit Act 1974, which renders a card issuer jointly and severally liable for the retailer's breach of contract, or the voluntary "chargeback" system, which allows the card issuer to reverse a payment made by card. However, the same protection is not available to consumers who make payment by cash, cheque or some other unprotected method. Further, the Report notes that business with financial problems may seek to increase prepayments from consumers (often on the pretext of granting further concessions to the consumers), who are often ignorant of the problems and unable to assess the risks, in order to improve cash flow.

In view of this, the Law Commission proposes that a consumer should be accorded with preferential status if their claim met all of the following criteria:

1. The claimant is a consumer as defined in the relevant Act. That is, the claimant is “an individual acting for purposes that are wholly or mainly outside that individual’s trade, business, craft or profession”.
2. The claim relates to a prepayment. In other words, the consumer has paid money to the insolvent business, and did not receive goods or services in exchange at the time nor have they received since.
3. The consumer has paid £250 or more during the six months immediately prior to the insolvency, either in a single transaction or in a series of linked transactions.
4. The consumer used a payment method which did not offer a chargeback remedy, and the prepayment is not protected in any other way, for example through insurance or trust arrangements.

The Law Commission believes that an additional category of preferential creditor would not add much complexity, delays and costs, since the limited preference is not designed to protect consumers in all circumstances. Rather, it would cover only the most serious cases,
where businesses take new (and substantial) cash payments from consumers in the run-up to insolvency.

**Hong Kong Situation**

Unlike their counterparts in the UK, consumers in Hong Kong seem to be in a worse position. In the absence of a statutory regime, consumers can only rely on the voluntary “chargeback” arrangements offered by credit card issuers in limited circumstances. A simple Google search will reveal that not all credit card issuers offer chargeback arrangements and even they do, card issuers do not always do enough to inform consumers about how to raise a chargeback claim and what documentation needs to be provided to the bank. The bank regulator’s executive director of the Monetary Authority, Carmen Chu, also warned that in some situations, where the banks paid the business in full first, before later on collecting the sum from credit card users in instalments, the customer is still obliged to make monthly repayments to the bank, even if the business has closed down.

In late 2015, the Consumer Council, upon reviewing the Companies (Winding Up and Miscellaneous Provisions) (Amendment) Bill 2015, expressed the view that the Government should give due consideration to the vulnerability of consumers as unsecured creditors in the event of corporate insolvency of a retail merchant. It was observed that unlike lenders, suppliers or investors, consumers lack the means to assess the information about the financial viability of the retail merchant and are not in a bargaining position to negotiate the terms to mitigate the default risk or insured against such risk. Therefore, the position of consumers should be moved up on the list of creditors receiving preferential payments. The Government was however of the view that making further distinction among unsecured creditors and according to some of them a higher payment priority will affect the interests of the other unsecured creditors. Moreover, it will make the payment mechanism even more complicated, prolong the winding-up process, and result in delay of payment to creditors.

**Suggested Way Forward**

The recommendations set out in the English Report are based on the fact that consumer prepayments made by card are sufficiently protected either under the statutory or voluntary chargeback scheme. In this regard, it is submitted that the Hong Kong Monetary Authority should issue Guidance to all credit card issuers on how to handle consumer claims in retailer insolvencies. If necessary, legislative regime should be introduced to implement a mandatory chargeback scheme. More importantly, information should be made available to consumers and the scheme needs to be more visible, and easier to access and use.

Further, it is not uncommon for businesses, which are on the verge of insolvency, to deliberately lure consumers to make prepayments or deposits knowing that there was a substantial chance that the goods or services would never be supplied. It is justified that
preference should be accorded to such consumers who make substantial prepayments or deposits to the businesses during the period immediately before insolvency.

Moreover, the act of deliberately procuring more customers when the company is insolvent or near insolvency could result in directors being liable for fraudulent trading under section 275 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32) if there is no reasonable ground to believe that the customers could obtain their prepaid goods/services. But it is very unlikely that consumers would be in a position to take action under the said section. In view of the vulnerability of the consumers, the Official Receiver should step up their investigation and prosecution against the directors under section 275.