

The Personal Insolvency Landscape

A bankruptcy update

December 2014

Introduction

A successful personal insolvency regime must strike the right balance: on the one hand, it should allow people to get back on their own two feet by relieving their indebtedness, whilst on the other hand, it should seek to return to creditors what is owed to them.

Fail to get this balance right and there are implications for financially distressed individuals, creditors and, ultimately, the whole of society. The health of the personal insolvency landscape has ramifications for us all.

While the UK is home to one of the world's most effective insolvency regimes, according to the World Bank, the scale and nature of personal debt in England & Wales has changed rapidly in the past decade, with insolvency numbers more than trebling in a short space of time; it's important that the insolvency regime changes with it. Without reform, indebted individuals will struggle to access a debt solution that is right for their situation – this exacerbates the debtor's problems and is of no benefit to creditors.

In January 2014, R3 sparked debate about the health of the personal insolvency regime with the publication of 'The Personal Insolvency Landscape', a set of proposals for reforming personal insolvency in England & Wales. Following discussions about the proposals with debt charities, insolvency practitioners, and policymakers, R3 believes there are more changes that should be made to the existing bankruptcy regime: the level of the creditor bankruptcy petition threshold and information and advice available for bankrupts.

Reform in these areas would also address points raised by Professor Elaine Kempson of the University of Bristol in her July 2013 government-commissioned report on the costs of insolvency that were not followed up on in the subsequent set of policy proposals announced by the Insolvency Service in February 2014. The Kempson Review was welcomed by the insolvency profession and others as a balanced and insightful look at some of the rougher edges of the personal insolvency regime – as yet though, very few concrete policy changes have followed the review.

Indeed, the government's record on personal insolvency reform has, to date, been one of missed opportunities. A 2011 call for evidence on the subject resulted in only minimal changes – despite calls, still being made, from the insolvency profession and debt charities for wider reform – while the parts of the personal insolvency regime that require the most urgent attention are often legislative anomalies that have been left untouched by policymakers for years. Crucially, government has not kept the reforms it has made under regular review to ensure they are working as intended.

The August 2014 call for evidence on Debt Relief Orders and the creditor bankruptcy petition threshold risks being another missed opportunity: despite stakeholders like R3 making the case for a comprehensive update to the personal insolvency regime, the review focuses on only isolated parts.

The government must go far further and faster on personal insolvency reform than it has done so far.

Taken alongside the earlier Personal Insolvency Landscape proposals, the proposals in this paper would have a significant positive impact on indebted individuals' ability to resolve their debts and on creditors' chances of seeing their money repaid.

What is bankruptcy?

Bankruptcy is a formal insolvency procedure that is designed to help indebted individuals repay as many of their debts as possible and return to financial health.

During a bankruptcy – which typically lasts for one year – creditors are not allowed to pursue the debtor ('the bankrupt') to reclaim money owed to them. Meanwhile, an Official Receiver or insolvency practitioner ('the Trustee') is appointed to oversee the bankrupt's assets. The Trustee is allowed to sell the debtor's assets to repay debts to the bankrupt's creditors. The process of selling the assets may take longer than the year-long bankruptcy term.

In most bankruptcies, the bankrupt's remaining debts are written off (with some exceptions) after one year and the bankrupt starts afresh.

Bankruptcies start with a bankruptcy order being made by the court. This order can be requested either by the individual themselves or by the individual's creditors: individuals must pay a £705 up-front fee to enter bankruptcy (to cover court and government administration costs); a creditor is allowed to 'petition' for a individual to be made bankrupt if the creditor is owed at least £750.

Recommendations for Reform

The government-commissioned 2013 Kempson Review¹ highlighted areas where bankrupt individuals can struggle within the existing bankruptcy regime. One key question raised by the review was whether such individuals have the ability to control the costs and fees associated with their case, especially in a situation where their bankruptcy stems from a creditor's petition relating to a relatively small debt.

The review outlines several factors that cause problems in this situation – many of these echo points made previously by R3 and others:

- The creditor bankruptcy petition debt level is still set at £750;
- The relationship between the Trustee and the bankrupt individual :
 - Bankrupts may fail to understand that the insolvency practitioner will have to take into account all creditors to whom they owe money when administering their bankruptcy, even those where the bankrupt is not in default. Individuals may believe that they only have to pay off the debt for which they were made bankrupt;
 - Lack of co-operation by the bankrupt individual with the Trustee can lead to higher fees;
 - Bankrupt individuals do not understand that the Trustee is permitted to charge fees to arrange the sale of their property as part of their administration of their estate.
- In order to alleviate some of these issues, the review recommended the government consider a number of measures and issues when proposing reforms – these are outlined below alongside R3's recommendations which aim to strengthen Professor Kempson's proposals.

1. Increasing the creditor petition debt threshold

Kempson: Increase the £750 creditor petition debt threshold

The minimum amount of money which a creditor must be owed before they are able to petition for an individual's bankruptcy (£750) is specified by Section 267(4) of the Insolvency Act 1986. This threshold has not been changed since 1986, meaning that creditors can still petition for a debtor's bankruptcy for what is, in today's terms, a relatively low level debt. Bankruptcy petitions are sometimes used to pursue low value debts by, for example, local authorities chasing relatively modest council tax or rates arrears.

If the threshold had been pegged to inflation from 1986, it would today be just over £1,900.

The review also points out that the threshold is now worth far less than the petitioning creditor's fees (around £3,000) or the Official Receiver fee (£1,715) and equates to only two or three hours of an insolvency practitioner's time.

The review says there is a 'very strong case' for increasing the petition threshold to a level that 'at the very least covers the creditor and court fees'.

Although the difference between the cost of the procedure and the value of the debt that would be recovered should act as a disincentive to creditors to petition for bankruptcy over a low value debt, creditor petitions for debts less than £3,000 account for almost one-in-ten such actions.

According to the Insolvency Service's August 2014 'call for evidence' on reforming the creditor petition debt threshold, there were 404 creditor petitions in 2013-14 for debts between £750 and £2,000 (3% of all 11,900 creditor petitions in that period). There were a further 575 creditor petitions for debts between £2,000 and £3,000 (another 5% of all petitions).

R3: Increase the creditor petition threshold to £3,000

There are a number of examples in insolvency legislation where statutory monetary thresholds or limits have lagged far behind inflation or changes in circumstance – the creditor's bankruptcy petition threshold is one of the more egregious.

Bankruptcy may be an effective way to help an individual deal with their debts, but it is not an option that is suitable for everyone. The relatively low value of debt for which an individual can be made bankrupt by a creditor risks people being placed in an insolvency procedure that is not suitable for their situation. It's also important to remember that a creditor's bankruptcy petition isn't consensual: it's a process where bankruptcy restrictions can be placed on an individual through no choice of their own, with serious implications arising from the bankruptcy process. This makes effective safeguards all the more important.

At the very least, the threshold level should be raised to where it would be had it been pegged to inflation back in 1986 – just over £1,900.

However, as the Kempson Review notes, this level still falls short of the costs involved in processing a creditor's petition (around £3,000).

As the Insolvency Service's figures show, petitions are still fairly frequently used for debts below £3,000. In insolvency practitioners' experience, even when the creditor has no intention of launching a petition for a debt below £3,000, their ability to do so is sometimes used as a 'threat' against debtors.

R3 believes that the creditor's bankruptcy petition threshold should be raised to £3,000. This level would both cover the petition costs and ensure an element of 'future-proofing' against inflation. The threshold level should also be kept under far more regular review by the government than it has been to date.

2. Introduce statutory referrals for advice for individuals subject to a creditor bankruptcy petition

Kempson: Extend section 273 of the Insolvency Act to creditors' petitions

Section 273 of the Insolvency Act 1986 allows the court to refer an individual with low level debts to an insolvency practitioner to assess whether a voluntary arrangement might be a better option for them than bankruptcy – but only where the individual has petitioned for their own bankruptcy.

The review recommends extending this section to cover cases where someone is subject to a creditor's bankruptcy petition.

R3: Widen the scope of section 273 of the Insolvency Act

R3 agrees with the Kempson Review that section 273 of the Insolvency Act 1986 be extended.

Firstly, the Section should be extended to cover creditor bankruptcy petitions as well as debtor bankruptcy petitions.

As the review notes, common reasons why bankrupt individuals may struggle to understand the fees and costs associated with their bankruptcy include a lack of knowledge about the process and non-cooperation with the Trustee. These can be problems in cases where the individual has petitioned for their own bankruptcy – it is almost guaranteed to be a problem (to some degree) where the individual has been made bankrupt by someone else.

Further, as R3 has repeatedly argued, indebted individuals need to be in an insolvency procedure appropriate to their situation: bankruptcy may simply not be suitable for someone subject to a creditor's bankruptcy petition and there must be an opportunity for the individual to consider their options with the help of a qualified professional.

With this in mind, R3 also recommends that the section should be amended so that a report may be produced on any alternative to bankruptcy, including statutory and non-statutory debt solutions. Currently, section 273 requires only that an insolvency practitioner assess whether a voluntary arrangement would be more appropriate for the individual. Such a binary choice is unnecessarily reductive and ignores other viable debt solutions.

Finally, R3 believes that section 273 should be amended so that someone subject to a bankruptcy petition can be referred to any regulated debt advisor rather than just an insolvency practitioner.

Anecdotal evidence from insolvency practitioners suggests that section 273 is barely used in its current form (some insolvency practitioners report seeing only one or two Section 273 referrals in the past three decades) and consequently has a limited impact on insolvency practitioners' time. In 2013, there were just under 5,400 bankruptcies started by creditor petitions: it would make sense to expand the pool of advisors to whom individuals can be referred to ensure there are no unnecessary backlogs in processing bankruptcy petitions and to ensure the provision of free advice via such referrals does not become a disproportionate burden for insolvency practitioners.

3. Better advice from the Insolvency Service for bankrupts

Kempson

The review argues that bankrupt individuals may not fully understand the implications of bankruptcy, the work involved in administering their bankruptcy estate, or the costs that may be incurred as part of that administration. It also argues that the Insolvency Service should provide an information sheet for bankrupts that details the work a Trustee will need to do in order to administer their bankruptcy estate, and which explains to bankrupts that, where they do not co-operate with the Trustee, there may be increased costs associated with their bankruptcy.

The review also recommends that creditors should be required to make individuals aware of the facts about bankruptcy before initiating bankruptcy petition proceedings.

R3

R3 agrees with the Kempson Review that the Insolvency Service should provide an information sheet for bankrupts to explain the work involved in administering a bankruptcy and the implications of not co-operating with their Trustee; creditors should also be required to provide information to indebted individuals before initiating a bankruptcy petition.

R3 believes there are three key points to consider:

- a) If a bankrupt feels the fees they have been charged for administering their estate are excessive, they can challenge what has been charged through the courts. While bankrupts already receive information about their rights in this regard when they are declared bankrupt, there is merit in this information being reiterated to them in any new guidance produced by the Insolvency Service.
- b) Guidance is provided to bankrupts **after** they have been declared bankrupt, but not necessarily **before**. Individuals could be provided with information about the consequences of bankruptcy at the same time as they are served with a statutory demand for repayment of a debt or other instances where creditors are taking action to recover a debt.
- c) Information about bankruptcy should be provided to individuals at all possible opportunities in the bankruptcy process. Information could be provided when: a bankruptcy petition is made by a debtor or creditor; when the bankruptcy order is made; when the bankrupt is interviewed by the Official Receiver as part of the initial enquiry into their affairs; when the Trustee reports to creditors about the bankrupt's affairs or any time the bankrupt receives a letter from their Trustee.

Conclusion

R3 was disappointed that the government's initial response to the Kempson Review failed to address a significant number of its recommendations around insolvency costs – specifically action on the creditor bankruptcy petition threshold and the extension of section 273 of the Insolvency Act. We hope the review of personal insolvency procedures announced in August 2014 will provide the impetus for these changes to be made; but believe the government should have gone much further

The UK's insolvency regime is ranked as one of the best in the world by the World Bank. It is an effective regime, but, as with anything, there are improvements that can be made. Important parts of England & Wales' personal insolvency rules have remained largely untouched since they were first introduced in 1986; the nature of personal insolvency has changed markedly in the past three years, let alone the last thirty. Constant review is necessary to make sure the personal insolvency regime keeps up with, or ahead of, the curve.

The key to any insolvency regime is balance and fairness: making sure that both creditors and debtors are protected and do not unfairly benefit at the other's expense.

While R3's Personal Insolvency Landscape paper addressed insolvency from both the creditor's and debtor's perspective, this further paper has focused on improving the debtor's experience of bankruptcy. It is important that insolvent individuals are in a debt relief procedure suitable for their situation, and that they understand the implications of entering formal insolvency; the existing personal insolvency regime falls short in ensuring that this is so. If adopted, R3 believes the recommendations in this paper and the earlier Personal Insolvency Landscape Paper could address these shortcomings.

Recommendations

- **Raise the creditor's bankruptcy petition threshold to £3,000.**
- **Extend section 273 of the Insolvency Act so individuals subject to creditors' bankruptcy petitions can obtain information on all possible alternative debt solutions**
- **Better information for bankrupts from the Insolvency Service.**