

Redressing the balance: strengthening the bankruptcy process and recognising prior behaviour

About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience of helping businesses and individuals in financial distress.

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The balance of bankruptcy

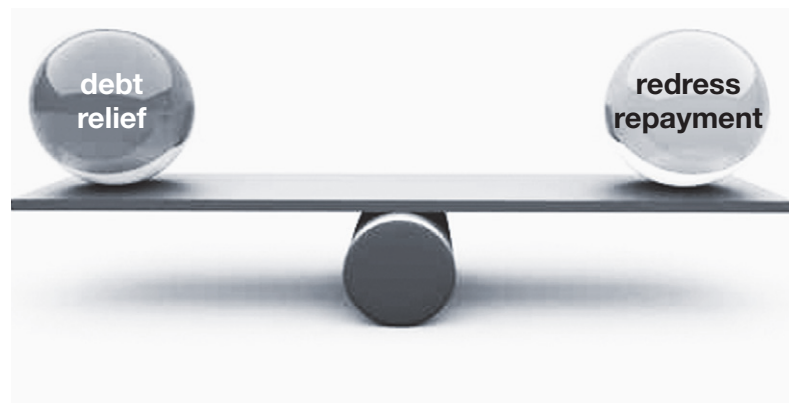
When evaluating the bankruptcy process, one of the central issues to be considered is how successfully it balances the competing interests of debtors and their creditors.

On the one hand, bankruptcy is a debt relief process. It is intended to provide a second chance to those who have become overburdened by debt and who have little hope of repaying their debts in full.

On the other hand, the lending environment is underpinned by lenders having the confidence that people cannot simply accrue debts and then walk away from them. The ability to borrow money, and at an affordable rate, is a vital part of the modern world – from mortgages to credit cards to car financing – but the more that bankruptcy is seen by lenders as a ‘soft option’ to write off debts, the more the cost of credit goes up and its availability goes down.

Ensuring creditors receive an adequate degree of redress and repayment through the bankruptcy process is crucial, not only to be fair to the creditors in each particular case, but also to support the lending environment by ensuring that bankruptcy, where appropriate, also acts as a deterrent to the non-payment of debt. A healthy lending environment requires a sufficiently robust bankruptcy procedure which upholds the principle that debts should be repaid.

This, then, is what we might call the balance of bankruptcy: on the one hand debt relief, on the other, redress and, where possible, repayment to creditors.



Research by R3 indicates that 64% of the public agree that people who are declared bankrupt should be treated differently depending on their prior spending behaviour and the reasons why they have gone bankrupt.

Relevant to achieving this balance in each case is, surely, how an individual has behaved prior to their bankruptcy. If they have arrived at their financial situation through little fault of their own – a good credit and repayment history followed by an unexpected job loss or a prolonged illness, for example – there would seem to be a case for focussing more on the debt relief side of the scales. In such cases, the role of bankruptcy as a deterrent seems unlikely to be the over-riding concern: such individuals’ behaviour prior to bankruptcy suggests that they already accept the principle that their debts need to be repaid but they are simply unable to do so due to their current circumstances. The priority in such cases is debt relief and a second chance to enter the economic cycle.

At the other end of the spectrum, if an individual has accrued their debts recklessly, with a callous disregard for repayment and the detriment caused to creditors, there would seem to be a strong case for making the terms of bankruptcy more onerous. In this situation, it seems only right that redress and repayment should be the priority if such behaviour is to be deterred.

What happens now?

Bankruptcy is a court procedure which can be started by the individual concerned or by a creditor owed £750 or more. The bankrupt's assets will then be realised for the benefit of creditors. Bankruptcy usually lasts for 12 months, at which point the individual will receive their discharge from bankruptcy and the majority of their debts will be written off, although assets can still be realised and the individual's Trustee in bankruptcy can still exercise his/her powers after discharge has occurred.

In addition to the assets which the individual owned at the date of their bankruptcy order, they may also acquire new assets, such as an inheritance in a will, after the date of their bankruptcy; this is known as 'after-acquired property'. Up until the date of their discharge, the Trustee in bankruptcy can claim after-acquired property for the benefit of creditors. However, the Trustee is not able to claim any new assets acquired by the individual after they have been discharged. The individual may still be required to make contributions to creditors from their surplus income for up to 3 years through an Income Payments Agreement or Order (IPA/O), but the Trustee in bankruptcy must also have applied for the IPA/O before the individual was discharged. Trustees must therefore act quickly when seeking to realise assets and obtain contributions from bankrupt individuals in the very short time period before discharge occurs.

The term of bankruptcy can be extended beyond 12 months (called 'suspension of discharge'), but only where either a Government official called the Official Receiver (OR), or an Insolvency Practitioner acting as the Trustee in bankruptcy can demonstrate to the court that the bankrupt has not co-operated with them or has not complied with their statutory duties under insolvency law since the date of the bankruptcy order. Suspension of a bankrupt individual's discharge therefore depends solely on their behaviour after they have been made bankrupt, not how they behaved in the run-up to bankruptcy.

The individual's behaviour leading up to the date of their bankruptcy, including their spending habits, the reasons why they went bankrupt and whether they have been dishonest or blameworthy in some way only becomes relevant if the OR decides to apply to court for a Bankruptcy Restrictions Order (BRO).

BROs were introduced by the Enterprise Act 2002 with three main aims:

- to protect the public and commercial community, by enabling the court to make a BRO so that a culpable bankrupt will continue to be subject to the restrictions of bankruptcy for a period of 2 to 15 years;
- to allow lenders and the public to differentiate between culpable and non-culpable bankrupts and make better informed decisions in their dealings with bankrupts; and
- to deter fraud and misconduct.

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What happens now?

Conduct which could lead the OR to apply for a BRO against the bankrupt individual is varied and can include the following:

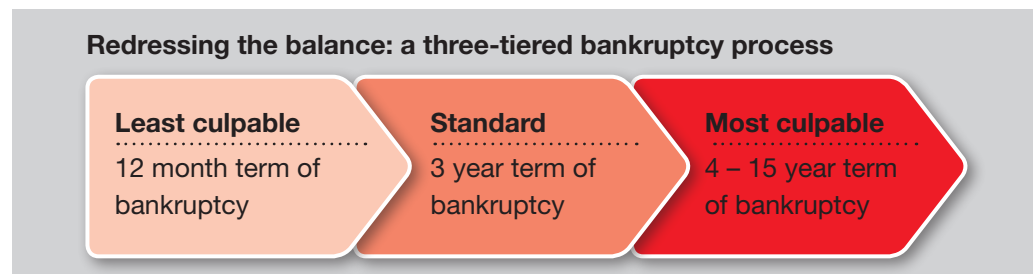
- incurring debts which the individual knew they had no reasonable chance of repaying;
- gambling;
- fraud;
- giving away assets or selling them at less than their value; or
- carrying on a business when the individual knew or ought to have known that they could not pay their debts.

The OR must apply for a BRO within 12 months of the date of the bankruptcy order. The court will then consider the OR's report, which details the reasons for bankruptcy based on the OR's investigations into the individual's background, financial history and any other evidence, before deciding whether to make the order.

If the court decides to make the BRO, the individual will then be subject to all of the bankruptcy restrictions - such as being unable to serve as a company director without permission from the court or having restricted access to credit over £500 - for an extended period of between 2 and 15 years. However, BRO/Us do not extend the term of bankruptcy so bankrupt individuals may therefore receive their discharge from bankruptcy after 12 months whilst at the same time being subject to a BRO/U for a number of years following discharge.

In general, the more blameworthy the individual's conduct, the longer the BRO is likely to last. Bankrupt individuals may also sign a Bankruptcy Restrictions Undertaking (BRU), which has the same effect as a BRO without the need for any court process. If the individual breaches any of the bankruptcy restrictions during the period of their BRO/U, they may be liable to criminal prosecution.

Redressing the balance



a) The standard term of bankruptcy

The current 12 month term of bankruptcy is among the shortest in any developed country.

Prior to 2003, the standard term of bankruptcy in the UK was 3 years, but was reduced to 1 year following the introduction of the Enterprise Act 2002. This change was introduced with the aim of promoting entrepreneurship by allowing those who had accrued debts through their business ventures to be swiftly rehabilitated and re-entered into the economic cycle. It was implicitly recognised that such a change tipped the balance away from the interests of creditors in favour of debtors, who would benefit from a significantly reduced discharge period, but this was believed to be a price worth paying for the wider economic benefits the shortened discharge period would deliver.

However, given that the vast majority of bankruptcies since 2003 have been domestic consumers rather than entrepreneurs in need of swift rehabilitation, it is difficult to see how a 12 month term of bankruptcy can still be justified. According to Insolvency Service statistics¹, in 2002 bankruptcies associated with trading or self-employed individuals accounted for just over 36% of all bankruptcies during the year, totalling 8,854 compared to 15,438 other bankruptcies. By 2007, three years after the Enterprise Act was introduced, the number of trading-related bankruptcies accounted for only 10.9% of all bankruptcies (a total of 7,058 compared to 57,422 consumer bankruptcies). Even though the figures for 2011 show a slight increase in the percentage of trading bankruptcies (just over 21% of all bankruptcies during the year), The Service has indicated that this is due to the decline in the number of consumer bankruptcies over this year². As with previous years, it remains the case in 2011 that the overwhelming majority of bankruptcies during the year were consumer-related (32,983 in total compared to just 8,893 trading-related bankruptcies).

As has been discussed, the availability and affordability of credit, which is vital to the modern economy, depends on a robust bankruptcy process which both provides a means of redress and recovery for creditors, and which acts as a deterrent to non-payment of debts. This would be undermined were bankruptcy considered to be an easy way for individuals to absolve themselves of their debts within a short period of time.

¹ Insolvency Service statistics table 2a – Bankruptcy orders by petition type and trading status, England and Wales, 2002 to 2012

² Insolvency Service statistics release 4th May 2012 – insolvencies in the first quarter of 2012

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Redressing the balance

Research by R3 indicates that 58% of the public believe that bankruptcy should last longer than 1 year.

R3 therefore believes that restoring the term of bankruptcy to 3 years would help redress the balance between bankrupt individuals and their creditors by:

1. Granting more time in which to apply for an IPA/O, if an individual's financial circumstances changed before their discharge from bankruptcy, thereby enabling the individual to make contributions to their creditors.
2. Increasing the amount of time in which after-acquired property could be claimed for the benefit of creditors before the individual receives their discharge.
3. Incentivising repayment of debts via procedures such as Individual Voluntary Arrangements (IVAs) by making the bankruptcy process a more robust procedure.
4. Allowing more time in which an undischarged bankrupt could enter an IVA if their financial circumstances improved before the end of the bankruptcy period, thereby providing increased returns to creditors.

R3 believes the standard term of bankruptcy could be extended from 1 year to 3 years.

b) 'Least culpable' bankrupts

The bankruptcy process in the UK currently makes no allowances for those who have arrived at their situation through little or no fault of their own. Those with fixed, and far from extravagant, outgoings can often find themselves heavily indebted in a remarkably short period of time when faced with a change of circumstances – a sudden job loss or a serious illness – or merely a combination of stagnant wages and a rise in prices.

These individuals may want to pay back their debts and would likely have done so under normal circumstances, but have, for reasons outside their control, become unable to do so and therefore could be termed as the 'least culpable' for their bankruptcy. This situation clearly differs from those who have run up debts to finance an unrealistic lifestyle beyond their means, or for example, those who have used credit cards to finance a gambling habit.

R3 believes there is a case for incorporating a distinction based on individuals' prior behaviour into the bankruptcy process. Alongside the restoration of the standard term of bankruptcy to 3 years, we suggest that the term could be reduced to 12 months in cases where the bankrupt individual is deemed to be 'least culpable' for their financial situation. The decision to reduce the term could be taken by a court or could alternatively be subject to the discretion of the OR in order to avoid the costs associated with a court process.

Clearly, any judgement on whether an individual can be considered 'least culpable' for their bankruptcy has to be based on the facts of each case, but relevant considerations could include:

- Sudden job loss
- Prolonged illness (physical/mental)
- Fixed and reasonable outgoings with stagnant wages and rising prices
- Illness/death of principal breadwinner
- Divorce/relationship breakdown

Redressing the balance

Above all, culpability should be determined by looking at the extent to which the individual can be said to be the author of their over-indebtedness. Those that cannot will, of course, still make a contribution to their creditors where possible through IPA/Os or the sale of applicable assets, as in any standard bankruptcy, but R3 believes that it would be fairer if their lack of culpability is acknowledged through a less onerous, shorter bankruptcy period than would otherwise be the case.

R3 believes that there is also merit in exploring an increase to the debt and asset thresholds for eligibility for a Debt Relief Order (DRO), which are currently set at £300 or less for assets and £15,000 or less for debts. An increase to these thresholds would assist in providing a cheaper debt relief solution for a proportion of those individuals who would otherwise enter bankruptcy, many of whom may likely fall within the proposed 1 year bankruptcy process for least culpable individuals.

R3 believes that the term of bankruptcy could be reduced to 12 months for the 'least culpable' individuals. The debt and asset thresholds for DROs should also be raised to provide more access to an alternative debt relief solution.

c) 'Most culpable' bankrupts

Reckless behaviour and culpability leading up to bankruptcy are currently dealt with by the bankruptcy process through BRO/Us. Yet, whilst BRO/Us extend the restrictions of bankruptcy, they do not extend the term of bankruptcy itself. As mentioned earlier, the term can only be extended where the bankrupt does not cooperate with their Trustee after the date of their bankruptcy, and cannot be extended for reasons of reckless or culpable behaviour before bankruptcy.

In practice, this means that individuals can be subject to a BRO/U and at the same time be discharged from bankruptcy. It also means that any new property acquired after discharge, even where an individual is subject to a BRO/U, can be retained by the individual, as only new property obtained before discharge can be claimed for the benefit of creditors. Equally, if the individual's circumstances change after discharge – their income increases dramatically for example – they cannot be made subject to an IPA/O as this can only be obtained prior to discharge, even if they are subject to an ongoing BRO/U. The current system can therefore cause problems for Trustees seeking to realise assets and obtain contributions from bankrupt individuals, including those deemed most culpable for their bankruptcy and subject to the BRO/U regime, in the short 12 month period before discharge occurs, which can have a knock-on effect on the eventual return available to creditors.

Where someone has been adjudged to have knowingly and deliberately engaged in actions that have led to their accrual of debt and eventual bankruptcy, as is acknowledged to be the case where a BRO/U has been obtained against an individual, there is surely a risk that their actions could be repeated in future. In such cases, R3 believes that there is a strong argument for ensuring that the bankruptcy process acts as a deterrent, both against the repetition of such behaviour by the individual concerned, and the copying of such behaviour by those similarly minded. R3 is concerned, however, that extending the restrictions, but not the term of bankruptcy via a BRO/U, does little to deter debtors from engaging in culpable behaviour again once the BRO/U has ended, or, indeed, to deter others from doing the same. Whilst the bankruptcy restrictions prevent bankrupt individuals from obtaining large amounts of credit or holding specific jobs or offices whilst they are in force, such restrictions may mean little to someone whose credit rating has already been affected by their bankruptcy and who would, therefore, find it difficult to obtain credit regardless of the extended period over which the bankruptcy restrictions apply to them.

Redressing the balance

Strengthening the bankruptcy process and the BRO/U procedure need not mean a return to the 'debtors' prison' but R3 believes that, in contrast to the current system, a more effective form of deterrence could be achieved through a revised bankruptcy process where extension of a bankrupt's discharge period would depend not only on their non-cooperation with their Trustee after the date of their bankruptcy order but also on their behaviour prior to bankruptcy. To achieve this, R3 envisages that the court could be given the discretion to suspend a bankrupt's discharge at the same time as imposing a BRO, so that the individual would remain both undischarged and subject to the bankruptcy restrictions until the end of their BRO/U period. Doing so would:

1. Act as a stronger deterrent to the reckless accrual of debt without hope of repayment, as there would be a real threat of the sale of newly acquired assets, and structured repayments to creditors in the form of an IPA/O, being imposed on individuals throughout a significantly extended discharge period. The potential loss of new assets or income would prove more of a tangible deterrent to reckless behaviour than merely extending the period over which the bankruptcy restrictions apply and would increase the potential money available to repay creditors.
2. Encourage the repayment of debts via other debt relief solutions, such as IVAs, by making bankruptcy a more robust procedure with a stronger element of deterrence to reckless or culpable actions prior to bankruptcy.

R3 believes that individuals subject to BRO/Us could also remain undischarged from bankruptcy for the duration of the BRO/U, subject to the discretion of the court.

Conclusions

Bankruptcy is a debt relief procedure and, as such, must provide a second chance for individuals who simply cannot repay their debts in full.

At the same time, it is vital to the confidence of lenders – and thus to both the cost and availability of credit - that creditors receive redress and repayment wherever possible in such situations, to uphold the principle that debts should be repaid.

In order to achieve this balance, R3 believes there would be merit in considering the introduction of a three tier bankruptcy process:

The standard term of bankruptcy could be increased to 3 years – allows for increased returns to creditors and incentivises repayment of debts where possible through alternative procedures.

The standard term could be reduced to 12 months for the ‘least culpable’ bankrupts – acknowledges individuals’ lack of culpability, providing much needed access to debt relief and swift rehabilitation. The debt and asset thresholds for DROs should also be raised to provide more access to an alternative debt relief solution.

Individuals adjudged to be ‘most culpable’ and made subject to BRO/Us, could have their discharge suspended for the duration of the BRO/U, subject to the discretion of the court – allows for increased returns to creditors and acts as a stronger deterrent to the reckless accrual of debt without hope of repayment – thereby upholding the principle that debts should be repaid.

