Bankruptcy

Over recent years there has been a dramatic increase in the number of people struggling with their debts. As a consequence, there has been a personal insolvency explosion, with the number of formal insolvencies increasing by almost 300% since 2002.

When an individual is struggling with their debts, there are a variety of options available to them, depending on their circumstances. Bankruptcy is just one debt solution, designed to free people from their debts after a period of time. In 2012, there were over 30,000 bankruptcies in England and Wales.

What is bankruptcy?

Bankruptcy is a formal court procedure which can be started by the individual concerned or by a creditor owed £750 or more. The bankrupt's assets will be realised for the benefit of creditors by either an Insolvency Practitioner (IP) or by a Government official – the Official Receiver (OR), either of whom can act as the bankrupt individual's Trustee in bankruptcy. After 12 months, when the bankrupt usually receives their discharge from bankruptcy, the majority of debts will be written off although assets can still be realised, and the Trustee can still exercise his/her powers, after discharge has occurred. Some repayments from surplus income may continue to be made for up to three years.

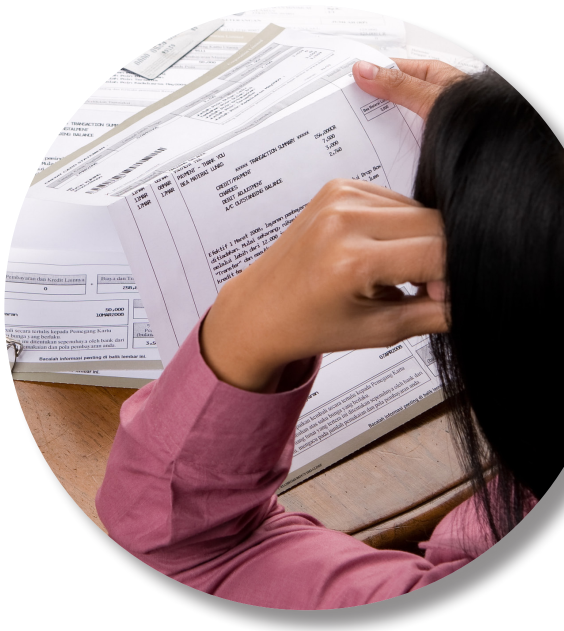
How does bankruptcy work?

Bankruptcy proceedings start with a bankruptcy order by the court. An individual can petition for their own bankruptcy, or a creditor who is owed £750 or more can apply to court to start bankruptcy proceedings. Once the order is made, control of the individual's assets passes to the OR, who is an officer of the court. The OR will manage the bankrupt's estate, pending the appointment of a Trustee. Where there are significant assets, an IP will usually be appointed to act as Trustee, either by a meeting of creditors or by the Secretary of State. Where no IP is appointed, the OR will act as Trustee.

Changes on the horizon

In November 2011, the Government consulted on proposals to reform the process of petitioning for bankruptcy. These proposals suggested that petitions for bankruptcy, in cases where there is no dispute between the parties, could be dealt with through an administrative procedure rather than by the courts. In October 2012, the Government subsequently announced that it would not be seeking to introduce reforms to creditor petitions for bankruptcy, but will press ahead with the introduction of changes to debtor petitions.

Where individuals petition for their own bankruptcy, there are certainly cases that could be adequately dealt with through an administrative process, provided the debtor is fully informed of the consequences of bankruptcy. R3 believes, though, that the more complex cases should still be subject to judicial input and that the Adjudicator,



who it is proposed would oversee the administrative procedure, should therefore have the discretion to refer such issues or cases to the courts for directions and guidance. Complex cases can include those involving individuals from overseas, those where there are pending matrimonial proceedings and cases involving debts that would not be discharged by the bankruptcy. In order to adequately distinguish between those cases that require judicial input and those that do not, R3 also believes that

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it is important that the Adjudicator has sufficient judicial and personal insolvency experience themselves.

R3 believes that certain debtor petition cases should continue to be subject to input from the courts and the Adjudicator should have the discretion to refer complex issues and cases to the courts for guidance.

The Adjudicator should have sufficient judicial and personal insolvency experience to identify those cases where judicial input is required.

What are the effects of being made bankrupt?

When an individual is made bankrupt, their assets will be sold to help pay their creditors, apart from any equipment needed for use in their business, and basic domestic belongings such as clothes, bedding and furniture. If they acquire any assets during the period of bankruptcy (called 'after-acquired property'), such as inheriting money, these can also be claimed by the Trustee and used to pay creditors.

During the period of bankruptcy, certain further restrictions apply to the bankrupt individual. For example, they are not allowed to obtain credit of more than £500 from anyone without telling that person he or she is currently bankrupt, and cannot act as a company director without the court's consent.

There are also special rules regarding the home of someone who has been made bankrupt. Generally speaking, if they have equity in a house, it may have to be sold. However, the law discourages a Trustee from taking steps to force a sale through the court during the first 12 months of the bankruptcy where the bankrupt individual owns the property jointly with another person or has family or dependants living with them. New rules introduced in April 2004 give the Trustee three years from the date of the bankruptcy order to sell the house or otherwise deal with the bankrupt person's interest in it. If the Trustee does not do so within that time, the property will revert to the bankrupt individual, and if the value of the equity is less than £1,000, it cannot be claimed by the Trustee at all.

If the OR believes that a bankrupt has been dishonest or is blameworthy in some way, the OR can apply to court for a Bankruptcy Restrictions Order (BRO) against the bankrupt. Conduct which could lead the OR to apply for a BRO is varied and can include an individual incurring debts which 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 to court for a BRO within 12 months of the bankruptcy order being made, although they may ask the court's permission to apply outside of the 12 month period. The court will consider the OR's report and any other evidence before deciding whether to make a BRO.

If the court decides to make the order, the bankrupt individual will be subject to all of the bankruptcy restrictions for an extended period of between 2 and 15 years. In general, the more blameworthy the individual's conduct, the longer the BRO is likely to last. Individuals can also voluntarily sign a Bankruptcy Restrictions Undertaking (BRU) which has the same effect as a BRO without the need for a court process. If the individual breaches the restrictions during the period of their BRO/U, they may be liable to criminal prosecution.

Case study:

The Official Receiver suggested that the bankrupt's gas and electricity expenditure should be limited to £90 per month, even though the actual payment required by the utility company was £120 per month, and suggested that the bankrupt should turn off their heating in December.

What happens to surplus income?

If an individual in bankruptcy has surplus income above their needs and those of their dependants, they may be required to make contributions towards repaying some of their debts. This can be done through an Income Payments Agreement or Order (IPA/O), which lasts for up to three years. Under current Insolvency Service policy, changed in 2010, those subject to an IPA/O who have more than £20 of surplus income each month are required to pay the surplus to their creditors. A provision of £10 each month is allowed to cover emergencies. Prior to 2010, the threshold for payment towards an IPA/O was £100 per month, at which point half would be used to pay creditors, leaving the bankrupt individual with £50.

Whilst payment for the administration of bankruptcy estates and returns to creditors are very important in maintaining a healthy insolvency regime and lending environment, it is not clear that lowering the repayment threshold in 2010 has actually improved returns. In a survey of R3 members released in 2012, only 1% of members thought the change had led to increased returns to creditors.

There are also concerns that £10 per month is very little to cover emergency expenses. Research conducted by HomeServe in 2010 showed that the average cost of repairing a broken boiler is approximately £350 and fixing water leaks amounts to almost £250. With only £10 per month to cover emergencies, it would take individuals several years to fix fairly common problems.

Additionally, the needs of a family or individual clearly change from case to case, and can also change over time. It is vital, therefore, that the Official Receiver is flexible both in deciding whether it is appropriate to apply for an IPA/O and in supervising them. Evidence from R3 members suggests that in a number of cases, the Official Receiver appears not to have shown sufficient flexibility and there is a concern that this could harm vulnerable individuals.

R3 believes that the monthly surplus income threshold for IPA/Os should be increased and brought into line with the current limit for surplus income in the DRO process, which is set at £50 per month. Individuals should also be allowed a reasonable surplus income for emergencies.

R3 believes that the Official Receiver needs to be flexible in their approach to IPA/Os

How long should bankruptcy last?

The 12 month term of bankruptcy is among the shortest in any developed country. This was shortened from three years by the Enterprise Act 2002, with the aim of promoting entrepreneurship through swift rehabilitation of debtors. The vast majority of people entering bankruptcy are, however, domestic consumers and it is therefore difficult to argue that the reduction in the bankruptcy period is justified on economic or entrepreneurial grounds.

Case study:

The Official Receiver pursued an IPO for £150 per month which the debtor could not afford. The court subsequently ordered that the debtor should contribute £20 per month after a number of hearings.

Bankruptcy is a debt relief procedure and it is therefore important that it treats bankrupt individuals fairly. At the same time, access to credit, which is vital both to individuals and the wider economy, depends on the confidence of lenders that they will receive a return. 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. The bankruptcy process must therefore be evaluated on how successfully it balances these competing interests of bankrupt individuals and their creditors.

Relevant to achieving this balance is how an individual has behaved prior to their bankruptcy. If they have arrived at their financial situation through little fault of their own – for example, a good credit and repayment history followed by an unexpected job loss or a prolonged illness – a lengthy term of bankruptcy may not seem appropriate. 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 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 and a longer bankruptcy term may be more appropriate. In this situation, it seems only right that redress and repayment, as opposed to debt relief, should be the priority if such behaviour is to be deterred.

R3 believes that the shortening of the term of bankruptcy was to the detriment of creditors, for little economic gain. Restoring the term of bankruptcy to three 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.
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 further believes that there is merit in exploring whether an individual's behaviour leading up to their bankruptcy could be taken into account when determining the length of their bankruptcy term. Alongside the restoration of the standard term of bankruptcy to three years, R3 suggests that for the least culpable individuals, such as those whose bankruptcy stemmed from a sudden job loss or illness, the standard term of bankruptcy could be reduced to the current 12 months, at the discretion of the OR or the court.

At the other end of the spectrum, for the most culpable individuals whose behaviour prior to bankruptcy led to a BRO/U being made against them for reasons such as fraud or incurring debts which they knew they would not be able to repay, R3 suggests that the term of bankruptcy could be extended beyond the standard three years. Under the present system, a BRO/U will extend the time over which the individual is subject to the restrictions of bankruptcy but not the bankruptcy term itself. The term of bankruptcy can only be extended where the individual refuses to cooperate with their Trustee after the date of their bankruptcy, and cannot be extended for reasons of reckless or culpable behaviour in the lead up to bankruptcy. R3 is concerned that this state of affairs does little to deter debtors from engaging in reckless behaviour again once their BRO/U has ended or to discourage other debtors from doing the same. R3 therefore suggests that the most culpable individuals subject to a BRO/U, who represent the highest risk to lenders and the wider economy, could have their discharge suspended for the duration of their BRO/U, potentially increasing returns to creditors in the extended period before their discharge from bankruptcy and acting as a further deterrent to reckless or blameworthy behaviour.

R3 believes that the standard term of bankruptcy should be extended from one year to three years.

R3 suggests that the revised standard term of bankruptcy could then be reduced to 12 months for the least culpable individuals.

R3 suggests that a Bankruptcy Restrictions Order/Undertaking could be accompanied by suspension of discharge for the duration of the BRO/U, thereby extending the term of bankruptcy for the most culpable individuals.

The cost of bankruptcy

To petition for their own bankruptcy, individuals are currently required to pay an up-front fee of £700, made up of a court fee (£175) and a case administration fee (£525). The court fee can be waived in certain circumstances, yet the case administration fee is never waived as this income enables the OR to administer bankruptcy cases.

By definition, many people facing bankruptcy do not have access to significant sums of ready money. It is counter-intuitive that people who are hugely indebted can find £700 to apply for bankruptcy, unless they go further into debt and/or avoid paying other creditors. For many people, an up-front fee is therefore a significant barrier to entering bankruptcy, even when it may be the most appropriate debt solution. A survey of R3 members revealed that 29% have seen debtors unable to afford to go bankrupt during the last twelve months, even though bankruptcy would have been appropriate. Asked what tends to be the next step for the debtor in this position, 58% said 'the individual does not address their debts'.

As a consequence of being unable to afford to declare themselves bankrupt, many individuals may be pushed towards inappropriate debt solutions, possibly making their situation far worse.

R3 believes that the up-front fee denies access to debt relief to the very people who need it most and we suggest two possible solutions:

1) **Allowing the case administration fee to be paid by instalments**

   Allowing people to pay by instalments would remove the barrier of the up-front fee, whilst preserving this vital funding stream for the Insolvency Service. As a safeguard, people paying by instalments would not be discharged until the fee had been paid in full. Alternatively the fee could be collected as a 'first charge' on the bankrupt's assets or via an IPA/O in cases where the bankrupt has sufficient assets or income. Where the individual has insufficient assets or income to cover the fee, any deficit could become a debt which survived the bankruptcy. In this way, the fee would be recouped albeit over a longer period of time.

2) **Increasing the debt and asset thresholds for Debt Relief Orders**

   Debt Relief Orders (DROs) are an insolvency procedure available to those with assets of less than £300 and with under £15,000 of debt for a significantly lower fee of £90. The restrictions on an individual under a DRO are the same as in bankruptcy, with the exception that there are

no payments to creditors, as there are no significant assets to realise. Increasing the debt and asset thresholds for inclusion in the DRO procedure would make DROs an option for many more individuals who have no significant assets from which to provide returns to creditors, but who are currently unable to access either bankruptcy, due to cost, or a DRO, due to the entry requirements. R3 therefore suggests that the asset threshold could be increased to £2,000 and the debts threshold to £30,000.

Case study:

An individual in the South West, despite selling her property to pay creditors, still had unsecured debts of over £140,000. She had pressing creditors that she found harassing and distressing, but simply could not find the £700 to go bankrupt.

What needs to change?

Insolvency trade body R3 believes that the bankruptcy process must maintain the right balance between the interests of debtors and creditors.

Bankruptcy must have serious consequences and creditors must be confident that, where possible, returns are maximised.

At the same time, it is vital that people struggling with their debts are able to access the most appropriate insolvency procedure for them.

R3 believes that:

- *Under the proposed new administrative process for debtor petition bankruptcies, certain debtor petition cases should continue to be subject to input from the courts and the Adjudicator should have the discretion to refer complex issues and cases to the courts for guidance. The Adjudicator should also have sufficient judicial and personal insolvency experience to identify those cases where judicial input is required.*
- *The monthly surplus income threshold for IPA/Os should be increased and brought into line with the current limit for surplus income in the DRO process, which is set at £50 per month. Individuals should also be allowed a reasonable surplus income for emergencies.*
- *The Official Receiver needs to be flexible in their approach to IPA/Os.*
- *The standard term of bankruptcy should be extended from one to three years.*
- *The revised standard term of bankruptcy could be reduced to 12 months for the least culpable individuals.*
- *A Bankruptcy Restrictions Order/ Undertaking could be accompanied by suspension of discharge for the duration of the BRO/ U,thereby extending the term of bankruptcy for the most culpable individuals*
- *Individuals should be able to pay the £700 cost of going into bankruptcy by instalments to help ensure that people access the correct insolvency solution for their circumstances.*
- *The debt and asset thresholds for Debt Relief Orders should be raised to allow more debtors who currently cannot afford to go bankrupt to access debt relief.*

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. **www.r3.org.uk**