

AF1/J02

Part 7: Bankruptcy

Bankruptcy is the legal process that can be used when individuals, not companies or partnerships, are unable to pay their debts. It clears the bankrupt's debt by liquidating most of their assets and using these to pay part of their creditors' debts. It enables the bankrupt to make a fresh start as all their previous debts are wiped out.

This milestones for this part are to understand:

- The bankruptcy process.
- How different assets are dealt with.
- The priority of payments to creditors.
- How the bankrupt's income can be affected.
- The process of release from bankruptcy.
- The alternatives to bankruptcy.

The bankruptcy process

A bankruptcy order can be made for one of three reasons:

- The debtor applies to become bankrupt (a voluntary bankrupt)
- A creditor who is owed more than £5,000 applies to make the debtor bankrupt (a forced bankruptcy)
- An insolvency practitioner makes an individual bankrupt because the terms of an individual voluntary arrangement (IVA) have been breached.

Voluntary bankruptcy

- A voluntary bankruptcy application is made on line. The fee is £680.
- The application will be considered by an adjudicator who works for the insolvency service.
- An interview will normally be conducted over the phone and occasionally with a face to face interview.
- If the adjudicator accepts the application
- The individual will be sent a copy of the bankruptcy order.

Forced bankruptcy

- A creditor must be owed at least £5,000 to commence procedure.
- Before applying to the court they must show that they have tried to recover the debt.
- Either by sending out a statutory demand for repayment and the debtor does not pay or come to an arrangement in 21 days.

- OR the creditor has attempted to enforce a judgement.
- The creditor can then go to the court and petition for bankruptcy which the debtor can challenge.

An Official Receiver (OR) will normally be appointed at the start of the process. This is someone who works for the Insolvency Service and is attached to the court. They will also be the bankrupt's Trustee in Bankruptcy unless an insolvency practitioner is appointed to that role.

The debtor's property passes to the Official Receiver. The debtor then must submit a statement of affairs listing their assets and liabilities to the OR within 21 days. The OR will then decide whether to call a creditors' meeting or simply interview the debtor. A creditor's meeting can be called if more than 10% of creditors (by value) demand this. They can also appoint an insolvency practitioner to act as the Trustee in Bankruptcy.

Once a bankruptcy order is made the bankrupt must:

- Disclose all property and debts to the trustee.
- Disclose any rise in income during their bankruptcy
- Not destroy or falsify any records of their affairs
- Not make any false statements to the trustee
- Not dispose of property with intent to defraud creditors
- Not fraudulently give preference to one creditor over another
- Not leave the country with any of their property.

In addition further restrictions will be placed on the bankrupt

- Must not obtain credit over £500 without disclosing their status.
- Act as a director without the court's permission.
- Create, manage or promote a company without telling the people you deal with of the bankruptcy.
- Work as an insolvency practitioner.

In practice the immediate effects of bankruptcy are likely to be severe.

- All bank and credit cards together with cheque books must be handed over to the trustee.
- The bank account will be frozen. However, the trustee can release money for daily living needs and to the other person if it is a joint account.
- If the bankrupt was self-employed the business will be closed.
- The bankrupt must continue paying any rent and any new debts incurred after bankruptcy.
- A note of the bankruptcy will stay on the person's credit file for 6 years after the order is made.

Bankrupts are also barred from certain posts such as a company director, chartered accountant or JP.

By becoming bankrupt the debtor loses most of their assets which are taken by the trustee in bankruptcy. The bankrupt can keep "tools of their trade", basic clothing and household furniture. There are special rules on certain assets.

Main residence

The trustee can only claim the equity, that is the difference between the market value and the outstanding mortgage. The lender has a claim to the outstanding mortgage amount. If the house is jointly owned the bankrupt is deemed to own 50% of the equity. Whilst the trustee has a legal claim to the equity, this normally cannot be realised until the house is sold but there are other ways of doing this.

If the mortgage is in arrears, the lender will normally seek to recover the debt by foreclosure. Sometimes this may pay off the debt but if it were insufficient to pay off the loan the bank would take part in the bankruptcy procedures to recover the balance. The same procedure applies to other secured assets.

When the house is solely owned by the bankrupt the equity and legal ownership are transferred to the trustee. A bankruptcy notice is added to the property on the land registry records. This means that any prospective buyer knows of the situation and the bankrupt cannot sell the property.

Where property is jointly owned the equity (normally 50% of the total) is transferred to the trustee. The title remains with the bankrupt and their partner, but the trustee will place a Form J on the land register. This means the trustee will be informed of any dealings in connection with the property sale.

The trustee has three years from the date of the bankruptcy to realise the equity. If no action has been taken by then the equity will be returned to the bankrupt.

The options open to the trustee are:

- Sell the equity to the spouse/partner of the bankrupt or a third party. There is a low cost conveyancing service if this option is chosen
- Place a charging order on the equity so that it will be repaid from the proceeds if the house is sold within 12 years. The amount of equity is the monetary amount at the date of the order plus statutory interest.
- Serve notice on the occupants to leave and then sell the property. A sale can be delayed by up to 12 months if the bankrupt's spouse or minor children living there. This does not apply to a co-habitee.

In all cases if the equity is less than £1,000 the equity is returned to the bankrupt. The Insolvency Act 1986 allows the interest to be returned before the three years has expired. Where there is little or negative equity and this is likely to be the case on the third anniversary,

the equity may be returned when reviewed 2 years and 3 months after the bankruptcy notice was issued

Life policies

These are part of the bankrupt's assets. If it has a surrender value, the trustee is likely to surrender it. If it is a protection policy with no current value, the trustee may allow it to be continued. Should the bankrupt then die the TIB would claim the proceeds.

Pensions

Registered UK pension schemes aren't included in the bankrupt's assets. If there is evidence that the pattern of payments prior to bankruptcy indicated they were made with the intention of avoiding them being taken by the trustee, these excess payments can be claimed.

Should the bankrupt die the trustee will claim any death benefit.

If the bankrupt is over 55 and can draw money from the pension, the trustee may force at least the Pension Commencement Lump Sum to be taken to pay off all or part of the debts.

Trusts

It is not uncommon for someone in financial problems to start transferring property to a third party. This could include a transfer to a trust

- If the transfer into the trust occurred more than 5 years before bankruptcy, the trustee in bankruptcy cannot claim these transfers.
- If the transfer occurred in the 5 years before bankruptcy, the trustee in bankruptcy can apply for a court order to get the transferred property back
- However, if the transfer was made more than 2 years before bankruptcy the TIB must prove that the bankrupt was insolvent at the time or became insolvent because of the gift
- These rules don't apply to a life policy under a MWPA trust even if the policy was taken out to defraud creditors. The only claim the trustee in bankruptcy can have is for the premiums paid if the policy was taken out to defraud creditors

The actions the TIB could take if the bankrupt is a beneficiary of a trust will depend on the type of trust.

- **Bare/absolute trust.** As the beneficiary can demand the property at any time the TIB can take this
- **Interest in Possession trust.** The beneficiary only has a right to income which the TIB could take. If the bankrupt had an immediate right to property, the TIB could take this. On the other hand, if the bankrupt was a remainderman whose right would only come into effect on the death of another individual, the TIB could not take this.

- **Discretionary trust.** As the bankrupt would not have a right to income or capital, the TIB could not force the trustees to advance either.

If the bankrupt is a trustee of a trust, there is no specific bar to them continuing but it is likely that the other trustees would seek to remove them'

Order of payment

The trustee sells all the available assets and uses the proceeds to pay off the creditors. The priority of payment is as follows

- The expenses of bankruptcy such as fees and costs
- Claims from any employees such as pension scheme contributions & up to four months owed remuneration.
- Other debts except to the bankrupt's spouse or civil partner
- Interest due on all debts since the bankruptcy order
- Debts to the bankrupt's spouse or civil partner

Each layer must be fully paid off before moving on to the next.

In practice most creditors will only be paid a fraction of what is owed to them. The creditors might only be offered 10p in the £ so someone owed £10,000 will only be paid £1,000

Bankrupt's income

The bankruptcy procedure will focus on the debtor's assets but the trustee can also put a claim on the bankrupt's income. It can make a voluntary arrangement with the bankrupt to pay a part of their income, including pension payments, to pay off some of the debts. This is called an **Income payments agreement (IPA)**. If agreement cannot be made it can seek a court order called an **Income Payments Order (IPO)**

These payments come from "surplus income" which is money left after paying your living expenses. The amount paid can also be varied if the individual's income changes. If the bankrupt is only in receipt of State benefits it is unlikely that these orders will be made.

Payments normally last for three years which is longer than the period of bankruptcy which is usually 12 months

Release from bankruptcy

Although not a pleasant experience bankruptcy can have benefits for the debtor. The bankrupt is free from all debts except for:

- Debts gained by fraud
- Maintenance and lump sum settlements under divorce and separation procedures.
- Damages for personal injuries
- Student loans
- Court fines
- Debts created after the bankruptcy order.

The Enterprise Act 2002 made a differentiation between what might be described an “innocent” and “guilty” bankrupt. The former would apply if someone’s business failed because their main customer had gone into liquidation. An example of the latter would be someone who continues to trade when they knew the business was doomed.

An innocent bankruptcy would normally be discharged within 12 months and their debts would be wiped out but the bankrupt’s property will still be retained by the trustee.

Someone who is deemed to be responsible for their problems or does not co-operate with the TIB may have to wait longer to be discharged.

Alternatives to bankruptcy

There are three potential alternatives

- Individual Voluntary Agreements
- Administration
- Debt Relief orders

Individual Voluntary Arrangements (IVA)

- An IVA is a formal agreement between a debtor and his or her creditors
- An IVA sets out how the debtor is going to repay the creditors usually over a period of five years
- It must be set up by a licensed insolvency practitioner
- The plan must be accepted by 75% of the creditors (by value) for it to be approved
- A bankruptcy order can be cancelled if the IVA has been approved

If the IVA fails the creditors can apply for bankruptcy

An IVA is designed to give a debtor more time to pay off debts and unlike bankruptcy allows the debtor to retain control of their property.

Administration Order

This is available if an individual has a County or High Court judgement against them and cannot repay this in full.

To qualify:

- The debt must be less than £5,000 including any interest and charges
- Money must be owed to at least two creditors
- The applicant must have a regular income and be able to prove that they can afford regular payments

An application is made and if the court accepts this it will decide

- How much of your debt has to be repaid
- How much your monthly payments will be
- How long the arrangement will last
- how much each creditor will get from the monthly payment.

Once granted the individual must keep up the payments or the court can:

- Ask the employer to take money from your wages
- Cancel the order

The order will be added to the register of Judgements, Orders and Fines but is usually removed 6 years after the order was made. As with an IVA if the debtor owns a business they can continue trading if they use an administration order

Debt Relief Orders

These are designed to protect individuals with low income and few assets who have debts of less than £20,000.

They are organised by the Insolvency Service who will serve an order on the debtor's creditors. They are then prohibited from taking further action against the debtor. At the end of the 12 months if circumstances haven't changed the individual will be freed from their debts.

To qualify the debtor

- Must be unable to pay their debts.
- Must owe less than £20,000
- Assets must be less than £1,000 although in addition they can have a car with a value up to £1,000
- After deduction of tax, NI and normal expenses their income must be less than £50 a month
- Must not be subject to another DRO within the last six years
- They must have been living or working in England or Wales for the last three years.

Only qualifying debts can be covered by a DRO. These include:

- Credit cards, overdrafts and loans
- Rent arrears, utility bills, phone bills, council tax and income tax.
- Benefits overpayments
- Hire purchase agreements
- Business debts.

That concludes this part so you should now understand:

- The process of becoming bankruptcy.
- How different assets are dealt with.
- The priority of payments to creditors.
- How the bankrupt's income can be affected.
- The process of release from bankruptcy.
- The alternatives to bankruptcy.

Further Reading

<https://www.citizensadvice.org.uk/debt-and-money/debt-solutions/bankruptcy-2/>

<https://www.gov.uk/bankruptcy>

<https://www.citizensadvice.org.uk/debt-and-money/debt-solutions/individual-voluntary-arrangements/>

<https://www.citizensadvice.org.uk/debt-and-money/debt-solutions/debt-relief-orders/>

<https://www.gov.uk/options-for-paying-off-your-debts/administration-orders>

<https://www.citizensadvice.org.uk/debt-and-money/debt-solutions/administration-orders/administration-orders-explained/what-is-an-administration-order/>