

**THE ENTERPRISE ACT 2002:  
CHANGES IN BANKRUPTCY  
LAW**

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## 1. INTRODUCTION

The *Enterprise Act 2002* (the “*Act*”) is an unusual piece of legislation, as it deals with two completely unrelated matters, namely on the one hand, competition and cartels, and on the other, insolvency. This booklet outlines the main provisions in relation to the changes in bankruptcy law contained in the *Act*.

The *Act* received Royal Assent on 7 November 2002. The main corporate insolvency provisions came into force from 6 April 2003. The bankruptcy provisions are expected to come into force early in 2004.

Part 10 (ss. 256-269) and Schedules 19-23 of the *Act* contains the provisions dealing with changes in bankruptcy law, many which have attracted considerable debate and criticism.

The main provisions are:

- the reduction of the duration of the bankruptcy, so that most bankrupts will be discharged after one year, sometimes less;
- the introduction of the Bankruptcy Restriction Order (“BRO”) and Bankruptcy Restriction Undertaking (“BUR”) to reflect “culpable conduct;”
- the introduction of post bankruptcy IVA's supervised by the Official Receiver;
- the removal of many bankruptcy restrictions, prohibitions and disabilities;
- the abolition of the crimes of failure to keep proper accounting records and gambling;
- the abolition of Crown preference;
- new provisions in relation to bankrupts' homes, which require the Official Receiver or a trustee in bankruptcy to commence the process of realising his interest before the third anniversary of the bankruptcy.

## 2. REDUCTION IN THE DISCHARGE PERIOD

### 2.1 Current position

Currently, in most cases, a bankrupt is automatically discharged from bankruptcy three years after the date of the bankruptcy order.<sup>1</sup>

Controversially, s 256 of the *Act* provides that the three year period for discharge of a bankrupt will be reduced to one year in most cases (and sometimes less), unless the Official Receiver or a trustee in bankruptcy applies to court for an order adjusting this period, on the grounds that the bankrupt has failed or is failing to comply with his obligations under the *Insolvency Act 1986*. The effect of any such adjustment is that the one year period ceases to run until the end of a specified period, or on the fulfilment of specified condition.

The discharge period may be less than one year, where the Official Receiver files a notice stating that the investigation of the bankrupt's conduct or affairs is unnecessary or concluded, in which case the bankrupt is discharged upon the filing of that notice.<sup>2</sup>

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<sup>1</sup> Section 256 of the *Act* substitutes the current s.279 of the *Insolvency Act 1986* with a new s.279. Under current law, the three year rule does not apply where the bankrupt has been an undischarged bankrupt within 15 years before the making of the bankruptcy order. In that case, the bankrupt can be discharged only by court order, upon an application made over 5 years from the date of the bankruptcy order. See s.279(1)(a) and s.280 *Insolvency Act 1986*.

<sup>2</sup> *Insolvency Act 1986*, s.279 (2), as amended by the *Enterprise Act 2002*.

Under the transitional provisions, a person who is an undischarged bankrupt when the relevant provisions of the *Act* come into force will be automatically discharged either 12 months thereafter, or when he would have been discharged under s.279(2) *Insolvency Act 1986*, if that date is earlier.<sup>3</sup>

## 2.2 Impact of discharge on bankrupt

The discharge of the bankrupt has no effect on the administration of his estate. The bankrupt's assets remain vested in his trustee, until the administration of his estate has been completed. The bankrupt remains under a continuing obligation to co-operate with his trustee after discharge,<sup>4</sup> and creditors may still prove in the bankruptcy after discharge.

However, until discharged, the bankrupt:

- may not act as a director, or take part in the management of a company, without leave of the court;<sup>5</sup>
- may not act as a receiver or manager of the property of a company on behalf of a debenture holder;<sup>6</sup>
- may not obtain credit of £250 or more without disclosing that he is a bankrupt;<sup>7</sup>

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3 *Enterprise Act 2002*, s. 256 (2) and Schedule 19.

4 *Insolvency Act 1986*, ss. 333(1) and (3)

5 *Company Directors Disqualification Act 1986*, s.11

6 *Enterprise Act 2002*, Schedule 21, s.1, which inserts a new s.31 into the *Insolvency Act 1986*

7 *Insolvency Act 1986*, s. 360(1) (a). There was a suggestion in the government's White paper, *Insolvency- A Second Chance*, that this limit might be increased to £500. If so, a new *Insolvency Proceedings (Monetary Limits) Order* will be introduced.

- may not engage in any business under a name other than the one in which he was adjudged bankrupt without disclosing that name;<sup>8</sup>
- may be subject to an income payments order.<sup>9</sup>

### 3. **BANKRUPTCY RESTRICTION ORDERS AND BANKRUPTCY RESTRICTION UNDERTAKINGS**

The perceived leniency towards the "non culpable bankrupt" in the *Act* is sought to be tempered by the post discharge restrictions, which enable the Secretary of State (or the Official Receiver, acting on a direction of the Secretary of State), to apply to the court for a bankruptcy restriction order ("BRO") against a bankrupt, to reflect culpable conduct, by imposing certain restrictions on the bankrupt.<sup>10</sup> Breach of a BRO will be a criminal offence, punishable by fine or imprisonment.<sup>11</sup>

The effect of a BRO is that, for a period of between two and fifteen years (as specified by the court), it shall be a criminal offence for the bankrupt to carry out certain acts, including being a company director, or being involved, either directly or indirectly, in

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<sup>8</sup> *Insolvency Act 1986*, s.360 (1) (b).

<sup>9</sup> *Insolvency Act 1986*, s.310. A new s.310 (6) is inserted by s.259 of the *Act*, which will require an income payments order to specify the period during which it is to have effect. This period may end after the bankrupt's discharge, but not after three years from the making of the income payments order. Section 260 of the *Act* also provides for the introduction of income payment agreements between the bankrupt and the Official Receiver or trustee, by which the bankrupt or a third party agrees to pay a specified portion of his income to the Official Receiver or trustee for a specified period.

<sup>10</sup> Section 257 *Enterprise Act 2002*, introducing s.281 *Post Discharge Restrictions* into the *Insolvency Act 1986*, and Schedules 20-21, *Enterprise Act 2002*. Schedule 2,0 *Enterprise Act 2002*, inserts a new Schedule 4A into the *Insolvency Act 1986*.

<sup>11</sup> *Insolvency Act 1986*, Schedule 4A, s.12, introduced by Schedule 20, *Enterprise Act 2002*

the promotion, formation or management of a limited company, without court permission.

In addition, a person subject to a BRO will be:

- disqualified from membership of the House of Commons, or of a local authority, or from voting in the House of Lords;<sup>12</sup>
- not able to act as a receiver or manager of a company's property, nor as an insolvency practitioner.<sup>13</sup>

Conduct to be taken into account by the court in deciding whether a BRO should be made, includes: <sup>14</sup>

- failing to keep records which account for a loss of property by a bankrupt or by business carried on by him;
- failing to produce records demanded by the Official Receiver or the trustee;
- entering into transactions at an undervalue or giving preferences;
- making an excessive pension contribution;
- trading while insolvent;
- failing to co-operate with Official Receiver or trustee;
- fraud or fraudulent breach of trust

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12 *Insolvency Act 1986*, s.426A, inserted by s.266, *Enterprise Act 2002*

13 Schedule 21, *Enterprise Act 2002*, introducing a new s.31 into the *Insolvency Act 1986*

14 *Insolvency Act 1986*, Schedule 4A, s.2 (2)(a)-(m), introduced by Schedule 20, *Enterprise Act 2000*.

The court is also required to consider whether the bankrupt was an un-discharged bankrupt at some time within six years before the bankruptcy to which the application for the BRO relates.<sup>15</sup>

To avoid court proceedings being pursued by the bankrupt, the bankrupt may offer a bankruptcy restriction undertaking ("BRU"), which has the same legal effect as a BRO.<sup>16</sup>

The provisions in relation to BROs and BRUs reflect the provisions of the *Company Directors Disqualification Act 1986*,<sup>17</sup> and the BRO procedure will be closely modelled on that applicable to the *Company Directors Disqualification Act 1986*.<sup>18</sup>

There will be a public register of BRO's and BRU's.<sup>19</sup>

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15 *Insolvency Act 1986*, Schedule 4A, s.2 (3), introduced by Schedule 20, *Enterprise Act 2002*.

16 *Insolvency Act 1986*, Schedule 4A, 7- 9, introduced by Schedule 20, *Enterprise Act 2002*

17 Section 6, *Company Directors Disqualification Act 1986*, deals with the disqualification of unfit directors of insolvent companies.

18 It is likely that, in determining the duration of a BRO, the court will apply the guidelines suggested by Dillon LJ in *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164, CA, at 171C-E; [1991]3All ER 578 at 581j to 582a, and 590j to 591j. Dillon LJ held that the appropriate period of disqualification which should be imposed under the *Company Director Disqualification Act* s.6 on a director who had been found to be unfit to be concerned with the management of a company was a minimum of 2 – 5 years' disqualification where, although disqualification was mandatory, the directors' conduct was relatively not very serious; 6 – 10 years where the directors' conduct, although serious, did not merit the maximum disqualification; and 10 years or more, in particularly serious cases, e.g. where the director had already been disqualified.

19 *Insolvency Act 1986*, Schedule 4A, s.12, introduced by Schedule 20, *Enterprise Act 2002*

#### 4. **THE INTRODUCTION OF POST BANKRUPTCY IVA'S SUPERVISED BY THE OFFICIAL RECEIVER**

The *Act* introduces a fast track procedure for a bankrupt to enter into an Individual Voluntary Arrangement (“IVA”) with his creditors after he has been made bankrupt. The Official Receiver (acting as nominee under the *Insolvency Act 1986*, Part VIII, *Individual Voluntary Arrangements*) will, if he thinks the bankrupt’s proposals have a reasonable prospect of being approved, put them to the bankrupt’s creditors.<sup>20</sup>

If the IVA is approved by the creditors, the bankruptcy order will be annulled. However, an annulment of a bankruptcy order in these circumstances will not affect existing BROs or BRUs, nor will it preclude the court from making a BRO, upon an application instituted before the annulment. An application for a BRO or BRU may not be made after annulment.

#### 5. **THE REMOVAL OF BANKRUPTCY RESTRICTIONS AND DISABILITIES**

Under the *Insolvency Act 1986*, bankrupts were prohibited from holding various professional positions or licences, for example, being appointed as Justices of the Peace or school governors. Many of these prohibitions, disabilities and restrictions (some of which were outdated, or were considered inappropriate), have been abolished.<sup>21</sup>

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21 *Insolvency Act 1986*, s.263, introduced by s.264 and Schedule 22, *Enterprise Act 2002*.

21 Section 265, *Enterprise Act 2002*, abolishes s.65 of the *Justices of the Peace Act 1997*, which disqualifies bankrupts for appointments as Justices of the Peace. Note that s.268 *Disqualification from office: general* empowers the Secretary of State to make an order in relation to a disqualification provision (which permanently or temporarily and whether absolutely or unconditionally) disqualifies a bankrupt or a class of bankrupts from being elected or appointed to an office or position, holding an office or position, or becoming or remaining a member of a body or a group.



## 6. THE ABOLITION OF CERTAIN BANKRUPTCY OFFENCES <sup>22</sup>

Section 263 of the *Act* abolishes the crimes of failure to keep proper accounts of business, and gambling and speculation.

## 7. THE ABOLITION OF CROWN PREFERENCE

The *Act* abolishes the preferential status of Crown debts (that is, Customs and Excise, Inland Revenue and social security contributions),<sup>23</sup> so that these rank as ordinary unsecured debts in the bankruptcy. Section 251 of the *Act* makes amendments to Schedule 6, *Insolvency Act 1986*, so that in future, the only categories of preferential debt will be:

- contributions to occupational pensions schemes;
- remuneration of employees (emoluments and holiday pay);
- levies on coal and steel production.

This is good news for unsecured creditors generally, as there will be a larger fund available for distribution to a greater number of creditors on a *pari passu* basis. The remaining categories of preferential debts are likely to have far less impact in a bankruptcy than in a corporate insolvency.

These provisions do not, of course, affect secured creditors, who rank ahead of all other categories of creditors in any event.

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<sup>22</sup> See *Insolvency Act 1986*, ss.361 - 362

<sup>23</sup> Preferential debts are the same in both corporate and personal insolvency. See s.386 *Insolvency Act 1986*.

## 8. THE BANKRUPT'S HOME

### 8.1 The current position

In the past, the Official Receiver or a trustee has been able to take advantage of long term fluctuations in the property market, to achieve higher realisations for creditors. All that is set to change. Under the *Act*, the Official Receiver or the trustee will be required to take formal steps to commence the process of realising such interests before the third anniversary of the bankruptcy order.

On the date of the making of a bankruptcy order (which date is taken as the "commencement" of the bankruptcy<sup>24</sup>), the bankrupt's estate automatically vests in the Official Receiver as trustee, or (upon the appointment of a trustee in bankruptcy), in the trustee.<sup>25</sup>

The bankrupt's "estate" comprises "*all property belonging to or vested in the bankrupt at the commencement of his bankruptcy*". (This includes any property, which is to be treated as falling within the estate by virtue of any other provision of Part IX *Insolvency Act 1986*.)<sup>26</sup> The trustee may also claim any property which is acquired by or devolved on the bankrupt after the date of the bankruptcy order (but before the date of his discharge), for the benefit of the estate ("after acquired property").<sup>27</sup>

Certain property, such as equipment necessary for use by the bankrupt in his employment business or vocation, and items needed by the bankrupt for

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24 *Insolvency Act 1986*, s.278(a)

25 *Insolvency Act 1986*, s.306

26 *Insolvency Act 1986*, s.283(1)

27 *Insolvency Act 1986*, s.307(1)

satisfying the basic domestic needs of himself or his family, are expressly excluded from the estate.<sup>28</sup>

In many cases, the major asset in a bankrupt's estate will be any interest the bankrupt might have in his or her home. Although this interest vests in the trustee without any conveyance, assignment or transfer,<sup>29</sup> the trustee will usually protect his interest by taking a formal step to prevent the property being sold without his knowledge. In the case of unregistered land, the trustee will register a writ or order under the *Land Charges Act 1925*. Where the land is registered, the Official Receiver or trustee will register either a bankruptcy inhibition notice or a caution against dealings, depending on whether the land is owned by the bankrupt alone or jointly with another. (In the latter case, the Official Receiver or trustee's interest is limited to the bankrupt's beneficial interest in the property).

There is no time period during which the administration of a bankruptcy estate must be concluded. As the law presently stand, therefore, it is not uncommon to come across situations where the Official Receiver registered an inhibition or caution on the title of a property in which a bankrupt has a legal or reputable interest, at the date of the bankruptcy or shortly thereafter, and then took no further action to realise that interest until many years later. This often happened when the bankruptcy order was made at a time when there was very little equity in the property. Unless the Official Receiver's interest in the property was purchased by a co-owner or third party, the administration of the bankruptcy would probably have been transferred to the Protracted Realisations Unit of the Insolvency Service, which has responsibility for

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28 *Insolvency Act 1986*, s.283(2)

29 *Insolvency Act 1986*, s.306(2)

dealing with the long term assets of bankrupts, such as real estate, pensions and life policies.

From the point of view of creditors generally and Insolvency Practitioners, this aspect of the new law is likely to be bad news. In a depressed property market, the Insolvency Practitioner appointed as a trustee in bankruptcy will not be able to wait for the economic cycle to improve before seeking to realise his interest in a property. This inevitably means that less money will be available for distribution to unsecured creditors, where an individual is made bankrupt at such a time. Inevitably, bankruptcies peak during poor economic cycles, and when the property market is likely to be depressed. The overall effect is that it is likely that there will be to be far fewer funds available for distribution to creditors.

On the other hand, it might be argued that bankrupts who continue to make mortgage payments post bankruptcy, in order to house themselves and their families, should be permitted to benefit from an improvement in the property market, particularly where their bankruptcy was not caused by “culpable” conduct. The current law has been criticised as being an “fee generation exercise for the trustee in bankruptcy”.<sup>30</sup>

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30 Vernon Dennis and Alexander Fox, *The New Law of Insolvency: Insolvency Act 1986 to Enterprise Act 2002*, 2003, The Law Society, at paragraphs 4.3.21 to 4.3.30

## 8.2 *The Enterprise Act 2002: the three-year rule*

Section 261 of the *Act* introduces a new s.283A into the *Insolvency Act 1986*, which provides that where a property comprised in the bankrupt's estate consists of an interest in a dwelling house, which at the date of the bankruptcy was the sole or principal residence of the bankrupt, the bankrupt's spouse or a former spouse of the bankrupt, that interest shall cease to be comprised in the bankrupt's estate, and shall automatically revert in the bankrupt at the end of the three years from the date of the bankruptcy.<sup>31</sup>

However, this provision shall not take effect if, within the relevant three year period, the trustee realises his interest in the property, applies for an order of sale or possession, applies for charging order over the premises in respect of the value of the interest under s.313 *Insolvency Act 1986*, or reaches agreement with the bankrupt regarding the interest.<sup>32</sup>

It should be noted, however, that the three year period will not start to run where the bankrupt does not inform the Official Receiver or the trustee of his interest in a property. In such cases, the three year period shall start to run from the date when the Official Receiver or trustee became aware of the interest.<sup>33</sup>

In addition, the court retains discretion to substitute the three year period for a longer period in prescribed circumstances or in other such circumstances as

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31 *Enterprise Act 2002*, s.283A(2), as inserted by s.261, *Enterprise Act 2002*

32 *Insolvency Act 1986*, s.283(A)(3), as inserted by s.261, *Enterprise Act 2002*

33 *Insolvency Act 1986*, s.283A(5), as inserted by s.261, *Enterprise Act 2002*

the court thinks appropriate.<sup>34</sup> This discretion might be exercised to protect the trustee's interest in the bankrupt's home, where, for example, there is evidence of a transaction at an undervalue or a preference, which the trustee is investigating, and the investigations or any subsequent litigation cannot be completed within the three year period.

### 8.3 **Low value homes**

The *Act* also seeks to protect the homes of bankrupts and their families, where the Official Receiver or trustee's interest is below a prescribed amount. In these cases, the court is required to dismiss an Application for sale, possession or a charging order over an interest in a bankrupt's home. <sup>35</sup> The "prescribed amount" is not yet known. However, "prescribed amount" is likely to include situations where there is either negative equity or very little equity in the home at the date of the Bankruptcy Order. Since the court is required to dismiss an Application for possession, sale or for a charging order over a low value home, the Official Receiver or trustee will no longer be able to protect his interest in a low value home, for example, by obtaining a charging order, and then sitting on this interest until the property increases in value.

### 8.4 **Pre commencement bankruptcies and transitional provisions**

Where the estate of an individual who is made bankrupt before the relevant provisions of the *Enterprise Act 2002* come into force, includes an interest in a dwelling house, that interest shall cease to be comprised in the estate and shall vest in the bankrupt at the end of the transitional period, unless the trustee has

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34 *Insolvency Act 1986*, s.283A(6), as inserted by s.261, *Enterprise Act 2002*

35 *Insolvency Act 1986*, s.313A, as inserted by s.261, *Enterprise Act 2002*

taken the steps previously mentioned to realise his interest in the property before or during the transitional period.<sup>36</sup>

## 9. CONCLUSION

The government's aim in reforming bankruptcy law was to move away from the so-called "one size fits all" approach of the current law. The government's objective was that the conduct of individual bankrupts should be taken into account, and, where appropriate, bankrupts should be subject to certain restrictions. At the same time, enterprise should be encouraged, a culture of responsible risk taking should be developed, and pressure on government resources should be alleviated.<sup>37</sup> The reasoning behind this approach is that the vast majority of bankruptcies (less than 2%) are not caused by fraud, and thus, the "stigma" of bankruptcy should be removed.

However, the interests of unsecured creditors have not been taken into account. Apart from the abolition of crown preference, the new law will do little to compensate or to console the unsecured creditors, who are the real losers in bankruptcy.

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<sup>36</sup> *Insolvency Act 1986*, s.313A (7) – (9), as inserted by s.261, *Enterprise Act 2002*

<sup>37</sup> *Bankruptcy – a fresh start*, Insolvency Service consultation paper. See also the Government White Paper, *Productivity and Enterprise. Insolvency – A Second Chance*. (Cm5234)