

TREATMENT OF SUBSTANTIAL EQUITY IN PTDS SUMMARY OF THE STATUTORY AND REGULATORY FRAMEWORK

The Accountant in Bankruptcy wrote to the RPB community in January 2016 regarding the increased number of trust deeds being granted with substantial equity in their properties, which equity is not being realised for the benefit of creditors.

The IPA has conducted a review of the prevailing statutory and regulatory framework, and provides this summary to practitioners to remind them of those provisions and assist them complying with expected standards of professional conduct.

This summary will also be used by our regulatory personnel in monitoring, inspection and complaint assessment contexts.

SUMMARY OF STATUTORY AND REGULATORY PROVISIONS

Conveyance of assets

On signing a trust deed, a debtor conveys their assets in whole to the trustee. This is a precondition of the trust deed becoming protected and happens in the context of wider trust law in Scotland and the creation of a trust. Assets that would not vest in a sequestration (bankruptcy) similarly cannot be realised by a trustee in a PTD.

The only asset that can be exempted from conveyance is the debtor's dwelling house, but certain key criteria apply. Unsecured creditors may object to the protection of the deed.

Reg 6 Exclusion of the debtor's dwelling house from a trust deed

A debtor can choose to exclude their dwelling house where it is their sole or main residence of the debtor, having an interest either solely or with another. There must also be a secured creditor. Unencumbered properties may not be excluded, nor can second properties (eg holiday homes or buy to lets).

The provision is intended to protect debtor's property from sale by trustee. On exclusion, a secured creditor cannot participate in the trust deed. This does not affect the secured creditor's rights to enter into security in event of default by debtor but the secured creditor cannot participate in the other assets of the trust deed and submit a claim. By agreeing to the exclusion of the property, the secured creditor agrees to postpone until after the debtor's discharge any right to pursue the debtor either by : sequestrating the debtor; doing diligence against the debtor's assets or participating in the PTD.

If the property is excluded, the debtor is not discharged of any existing or subsequent liability to the secured creditor (i.e. any shortfall) whenever it arises. If the property is included, then the debtor is discharged of any unsecured liability to the secured creditor regardless of when the shortfall arises. AiB Guidance suggests excluding a property where there is minimal, no or negative equity. However, it should be noted that in doing so, the debtor will become liable for any actual shortfall after the conclusion of the deed and this should be considered in the context of the information and explanations provided to the debtor.

Arguably a debtor could choose to exclude where there is equity, substantial or otherwise. A secured creditor would likely support that request on the grounds that their financial position is protected due to the equity position. However in practice the debtor may need to propose a contribution towards the value of the equity excluded otherwise the unsecured creditors may object to the trust deed becoming protected.

Reg 15 and Form 1B

Separately to the exemption provisions, in conjunction with the signing of the deed, the Trustee may agree with the debtor not to realise any specified heritable property that has been conveyed under the deed (Reg 15) and using Form 1B to record the terms of the agreement, but such agreement is conditional on the debtor paying an amount of money on a given date or by increasing the period of contributions past the current 48 months. The use of such an agreement is not mandatory. The purpose however is to agree the equity level at the outset, and ensure that all parties (debtor, creditors and Trustee) know up front how much equity exists, and how it is going to be realised. Those two figures may not be the same. A variety of options and approaches are available to the trustee and debtor as to how the equity in the property will be treated. If Form 1B is used, a copy **must** be included in the paper work sent to creditors pre-protection in terms of Reg 10.

The concern expressed by the Accountant in Bankruptcy is that in an increasing number of cases with substantial equity contributions are being extended for 1 year, and that in some instances, these additional contributions fail to adequately represent the value of the equity available to creditors. Whilst this may be consistent with the approach adopted under the IVA protocol, it should be remembered that the Protocol is not of application in Scotland.

Reg 15(4) requires that any payments determined by the Trustee must be determined in accordance with a valuation made by a chartered surveyor or other suitably qualified third party of the debtor's property as at the date of the grant of the trust deed.

Solvent trust deeds

The Accountant in Bankruptcy has noted that in some cases the equity in the debtor's property considerably outweighs the debt owed. In that case the debtor is solvent. Reg 8(3) states that a Trustee may determine a shorter payment period (than 48 months) only if in the opinion of the trustee, payment of the debtor's contributions (from income or otherwise) during the shorter period would allow distribution of the debtor's estate to meet in full the total amount of debt including interest. In that scenario the Regulations envisage that the creditors will be paid in full and that sufficient equity or income will be made available to the creditors to do so.

Creditors Rights to Accede/Not Accede

The stated remedy for creditors, who do not support the terms of the trust deed as it is presented to them, is to object to the protection of the deed (Reg 10). Creditors have to actively object to the terms of the trust deed, otherwise they are deemed to have consented (whereas in an IVA consent must be actively provided). Trustees therefore rely on the tacit approval of creditors.

To facilitate the exercise of these rights, practitioners are obligated to provide transparent disclosure may be found in SIP 3.3 (summarised below).

Protection of PTD

The process of protection is set out in Reg 11 and requires the trustee to send various documents to the Accountant in Bankruptcy (Reg 11(1)(a)).

11(2) sets out the requirement of the Accountant in Bankruptcy: he must register the trust deed in the RoI if (a) he has received all of the documents required (b) the conditions set out in Reg 4 to 10 are met and (c) unless he has an issue regarding the contribution.

Where all the documents are submitted correctly, then the grounds of refusal are:

- i) quantification of contributions; or
- ii) that in some way Regs 4 to 10 have not been adhered to.

Provided adherence to the requirements of Regs 4 to 10 are demonstrated, the Accountant in Bankruptcy can only refuse protection per Reg 11(2) on the grounds that the contribution sought is not in line with the Common Financial Statement. That view is supported by Reg 27(1)(a) where an appeal against the failure to register a trust deed is only on the basis that the Accountant in Bankruptcy is not satisfied about the expenditure or contribution. The Accountant in Bankruptcy cannot refuse to protect on the terms of the trust deed, and must also rely on the (tacit) acceptance of the terms of the trust deed.

Post Protection

Reg 19 allows the Accountant in Bankruptcy to issue directions to the trustee under a protected trust deed. Reg 19 (1) allows the Accountant in Bankruptcy to give directions as to how the trustee should conduct the trust. Reg 19 (3) states that the direction may be issued on the initiative of the Accountant or (at the Accountant's discretion) on the request of the trustee, debtor or any creditor, with timescales for compliance, appeals, and remedies for non-compliance also set out in the Regulation.

Sheriff's direction

There is the possibility of taking any matter to the sheriff court in terms of Reg 28(1) for a decision of the Court. Any person with an interest may at any time apply to the sheriff for a direction as regards the administration of the deed.

Available guidance

The relevant sections of SIP 3.3 and the Accountant in Bankruptcy Guidance for Trustees under PTDs pertaining to the provision of information and the treatment of equity are as follows:

SIP 3.3

Para 8: if a trust deed is proposed, an IP should ensure that a fair balance is struck between the interests of the debtor and those of the creditors.

Para 9: the initial circular to creditors the insolvency practitioner should provide clear and accurate information to enable creditors to decide whether or not to object to the Trust Deed becoming protected and he should advise of the procedure for objections. At all times an insolvency practitioner should report accurately and in a manner that aims to be clear and useful.

Para 22: If any asset is not going to be realised, or not realised in full, the reasons for this must be clearly explained in writing to creditors when the Trust Deed is presented to them for consideration for protection, or at any other time that such a decision is taken.

Para 32: Where heritable property is to be included in the Trust Deed the insolvency practitioner must ensure that the debtor is clearly advised that all such heritable property, including the debtor's home unless excluded, is covered by the Trust Deed. The debtor must also be advised that equity in the property requires to be realised for the benefit of the creditors.

Para 37: The Trustee's attention is drawn to the provisions in the Accountant in Bankruptcy's guidance notes relating to heritable property (see below).

Accountant in Bankruptcy Guidance Notes for Trustees under PTD

2.7.1 The debtor must provide information about all their assets, regardless if the trustee does not propose to realise an asset. The trustee must ensure that they identify and circularise details about all the debtor's assets which are conveyed as a result of the trust deed being granted and provide a reason why any asset is not to be realised in full during the administration of the trust deed.

2.7.3 It is particularly important to ensure that the debtor fully understands that the trustee can seek to realise the full value of any assets which they own and that this includes any equity in the debtor's family home, unless the dwelling house is excluded.

2.7.7 When an asset of the debtor is conveyed to the trustee, the trustee must seek to realise the full value of the asset unless the trustee can demonstrate that sufficient funds can be realised from other sources, in order to maximise the dividend payable to creditors.

2.9 Agreement in respect of a heritable property

2.9.1. This section does not apply to the debtor's dwelling house if it has been excluded from the trust deed by virtue of section 5(4A)(b)(i) of the Act.

2.9.2. The trustee can agree not to realise any property that has been conveyed to him by virtue of the trust deed and to relinquish his interest in such a property and recall any notice of inhibition, on condition that either the debtor: pays an amount, by a specified date, as determined by the trustee; pays additional monthly contributions after the end of the 48 month payment period, for a period specified by the trustee, and co-operates with the trustee.

2.9.3. An agreement between the trustee and debtor to pay funds to remove the trustee's interest in their property must be recorded on Form 1B, as recorded in the Schedule to the 2013 Regulations.

2.9.4. A copy of Form 1B is to be sent to The Accountant and every creditor known to the trustee.

2.9.5. The trustee must determine the amount and period of the contributions to be paid, based on a professional valuation of the heritable property and the redemption figures for any debt secured on the property as at the date of granting of the trust deed. A chartered surveyor or other suitably qualified third party should complete the valuation. The valuation should detail the maximum market value. The valuation should be specified as the current Royal Institution of Chartered Surveyors (RICS), Red Book equivalent of "Open Market", and not impose other restrictions such as a forced sale or the sale price expected for a transaction concluded within a truncated period. The valuation documentation, including detail of the work undertaken to provide the property valuation must be available if requested by creditors. It is important to recognise that 100% of the assets are conveyed to the trustee in a trust deed. This means that 100% of the difference between valuation and security needs to be shown in the debtor's statement of affairs. Any differences between the full equity figure recorded in the statement of affairs and the amount that is expected to be realised, as recorded on the Form 1B, must be fully explained.

2.9.6 It is possible at the outset that the options for dealing with heritable property have not been fully established. This could be, for example, where re-mortgaging is an option to be explored prior to consideration of property sale or additional contributions in lieu of equity at the end of the PTD. In these circumstances, it is essential that creditors are presented with a complete

and realistic assessment of the actions that may be undertaken by the trustee in relation to property. The following should be provided as additional information to the Form 1B: Trustee's intentions with regard to sale of property to realise full equity and reasons for not proceeding with this course of action if appropriate. Plans for potential re-mortgaging including the timing of any proposed action and the evidence that will sought to verify that reasonable steps have been taken to obtain a mortgage. As an example, this could include the debtor providing decision notices for two separate applications for re-mortgage; the proposed additional contributions that will be taken in lieu of equity, including the timing and duration of these. A statement detailing the comparison between, the potential dividend to creditors should the equity be fully realised, against, the potential dividend, if additional contributions are taken after the initial 48 month period.

2.9.7 In circumstances where the proposals in relation to heritable property remain unclear, the Form 3 should record the minimum expected return on the property. It would only be appropriate to record a higher figure where firm arrangements have been made e.g. a re-mortgaging agreement is in place or another suitable guarantee to purchase an interest in the debtor's property has been obtained. The Form 3 should not include a speculative figure against total realisations from heritable assets.

2.9.8 If the debtor does not comply with the Form 1B agreement, the trustee may withdraw from the agreement and sell the property

2.9.9 If the property is sold, regardless of the circumstances that lead to the sale, the trustee will receive the full amount of available equity and the amount agreed and recorded in Form 1B no longer applies

REGULATORY APPROACH

Insolvency practitioners are required to comply with the prevailing statutory and regulatory framework; both specific to PTDs and more generally, in relation to their professional conduct.

Whilst it is acknowledged that there may be instances where it may be appropriate not to insist on endeavouring to realise the full value of the debtor's interest in heritable property (e.g. because of concerns about vulnerability issues for the debtor or spouse/ family members, or other exceptional circumstances, and/or the availability of re-financing) the framework is such that it is incumbent upon the practitioner to explain why that proposed treatment strikes a fair balance between debtor and creditors, **in the particular circumstances of each case**. In all instances, practitioners should be fully transparent about the proposed treatment of equity in a PTD.

Failure to strike a fair balance and/or to be transparent when seeking to do so, or to comply more generally with the statutory and regulatory framework, may fall short of expected professional standards. Consequently, such departures could form the basis of an adverse inspection or monitoring outcome and/or a formal complaint from an affected party.