Individual Voluntary Arrangements and fraudulent debts

We have recently received several queries from advisers asking how debts incurred through fraud should be treated in Individual Voluntary Arrangements (IVAs).

In bankruptcy, debts incurred through fraud or a fraudulent breach of trust prove in bankruptcy but under s281(3) of the Insolvency Act 1986 (IA1986) a debtor's residual liability will not be extinguished upon discharge. However, there is no equivalent provision in respect of IVAs and so the position on how fraudulent debts are treated is less straightforward.

The legal resource "Tolley's Insolvency Law Service" at [D6014] states:

"For the purposes of an IVA, section 257(3) of IA 1986 provides that the creditors that are entitled to participate, both in terms of voting at the creditors' meeting and receiving a dividend, include 'every person who is a creditor of the bankrupt in respect of a bankruptcy debt' [Including creditors whose debts were incurred through fraud].

The terms of the IVA depend on the proposals put forward by the debtor. Subject to this there are no provisions in the IA 1986 or the Rules that impose a continuing liability on the debtor in respect of the debts mentioned at section 281(3)-(6) or Rule 6.223 (now rule 10.146 of the Insolvency Rules (England and Wales) 2016). A creditor is bound by the IVA if (a) he was entitled to vote at the creditors' meeting (whether or not he was present or represented at it), or (b) he would have been so entitled if he had had notice of it (IA 1986, s 260(2)(b), as substituted by IA 2000)."

It follows that it is possible, subject to the terms of the IVA, for a debtor to be released from liability for fraudulent debts at the end of the IVA, whereas such debts would not be released upon discharge from bankruptcy by virtue of 281(3) IA 1986 (*Bradley-Hole (a bankrupt), Re [1995] 4 All ER 865* at 886).

The fact that a creditor may not have received notice of the creditors meeting does not prevent them from being bound by the resulting IVA under s262(2)(b)(ii) IA 1986. The

reasons the creditor did not receive the notice do not affect this rule. However, a creditor bound by the IVA who did not receive notice could challenge the IVA on the basis of 'material irregularity' (*Re T&N Ltd and others* [2006] EWHC 842 (Ch)) paragraphs 16, 17 (see below).

Under s260(2A), if the IVA concludes successfully and a person bound under s262(2)(b)(ii) has not been paid (because they did not receive notice) then the debtor will become liable for the amount payable under the IVA to that creditor. See Halsbury's Laws of England [69] 'Effect of an IVA'. However, this would not result in a debtor being liable for any residual liability in excess of the amount that the creditor was due to receive in the IVA, even if a debt was fraudulently incurred.

Challenging the approval of an IVA

S262(1) provides that a debtor or creditor bound by the IVA can apply to challenge an IVA's approval on the basis that:

(a) it unfairly prejudices the interests of a creditor of the debtor or;
(b) that there has been some material irregularity at or in relation to such a meeting in relation to a creditors' decision procedure instigated under that section.

A creditor challenging the approval of an IVA can request that the approval is revoked or suspended (s262(4)).

Unfair prejudice

In *JP v A Debtor [1999] 2 BCLC 571 at 586,* it was held that a woman owed a matrimonial debt would be unfairly prejudiced if her debt were to be included in an IVA because unlike the other IVA debts, hers would not be discharged by bankruptcy (by virtue of s281(5) IA 1986). She was thus granted an extension of time to set aside the IVA.

This approach was approved in a later case concerning the inclusion of Child Maintenance arrears in an IVA. *Child Maintenance and Enforcement Commission v Beesley & Anor* [2010] EWCA Civ 1344 held at paragraph 64 that the CMEC would be unfairly prejudiced by the inclusion of their debt for the same reason i.e. that they would be free to recover their debt post discharge (also by virtue of S281(5)), were the debtor to be adjudged bankrupt, but that the same debt would not survive an IVA. It is worth noting that child support arrears are now specifically excluded by s382 IA 1986 as amended by s142 of the Welfare Reform Act 2012.

A creditor whose fraudulent debt was bound by an IVA would appear to have a strong application to challenge its inclusion based on undue prejudice. Whilst the identified authority discussed relates to debts which would not prove in bankruptcy, it is difficult to see why fraudulent debts would be viewed any differently to the other types considered in the cases above which are also caught under s281. Indeed, given that applicants are victims of fraud the case for unfair prejudice may be even stronger.

Material irregularity

The other ground for challenge is 'material irregularity'. As discussed above in *T&N Ltd and others* it was held at para 17:

"An obvious irregularity is a failure to give notice to a person who should have received it. If therefore, through oversight, notice is not sent to a creditor whose claim, name and address is known to the administrators, there has been an irregularity in relation to the meeting. If the

creditor or his address is unknown, there was no obligation (or ability) to send notice to him and there will not have been an irregularity."

Time limits

The time limits for making such challenges are tight. Section 262(3)(a) challenges may not be made 'after the end of the period of 28 days beginning with the day on which the creditors decided whether to approve the proposed voluntary arrangement or, where a report was required to be made to the court under section 259(1)(b), the date on which the report was made.'

Under s262(3)(b) a creditor who should have been but was not given notice of the creditors' decision procedure may make an application to challenge the decision within 28 days of his becoming aware that the creditors' decision procedure has taken place. It is no bar to his making an application (within 28 days of his becoming aware of the procedure) that the arrangement has ceased to have effect, unless it came to an end prematurely…' (Schaw Miller and Bailey Personal Insolvency Law and Practice at [6.369])

So, importantly, a creditor who has not had notice of an IVA can make an application to challenge the IVA under s262(3) even if the IVA has already concluded successfully. S376 IA1986 provides …'the court may extend the time, either before or after it has expired, on such terms, if any, as it thinks fit'. The court commented in *Plant v Plant [1998] 1 BCLC 38 at 54* on the exercise of this power in relation to s262 applications: 'it is anticipated that the court will be slow to extend the time limit; an extension will require special circumstances.'

In *JP v A Debtor* the time limit was extended despite nearly ten months having expired have before the application was made, on the basis that granting the extension would not prejudice the debtor, but not doing so would unfairly prejudice the applicant. However, the court took a different view in *Timothy, Re [2005] EWHC 1885 (Ch), [2006] BPIR 329* which held 'the CSA was not permitted to challenge an IVA which extinguished the debtor's obligation to pay maintenance for his 10-year-old daughter where the application was made some nine months' out of time' (Schaw Miller and Bailey [6.398]).

So, a creditor wishing to make a s262 challenge should do so within the time limit and not assume they will necessarily be granted an extension of time.

If a creditor does not make a successful s262 challenge then, unless they can successfully petition for the debtor's bankruptcy under s264(1)(c), s276(1) it appears the debtor's liability for the fraudulently incurred debt would be released when the IVA is concluded.

The approach of Insolvency Practitioners (IPs) in practice

The IVA Standard Protocol 2016 standard conditions confirm at 4(4):

"4(4) After the arrangement has begun, no creditor may, in respect of any debt to which the arrangement applies:

(i) take any action against your property or person; or

(ii) start or continue any action or other legal proceeding against you."

So, for protocol compliant IVAs, creditors will be bound by this condition in accordance with s260.

In practice, some agencies whose fraudulent debts are included in protocol compliant IVAs will continue to unlawfully enforce their debts. For example, benefits agencies will continue to recover fraudulent benefit overpayments from ongoing awards (which should stop upon approval of the IVA in accordance with condition 4(4)).

One IP stated that supervisors would not generally challenge this continued recovery of fraudulent benefit overpayments because it was impractical for supervisors to do so. In many cases the legal costs of a challenge would exceed the funds paid into the IVA. It would therefore fall to the debtor to challenge such unlawful deductions themselves, either by formal complaint or court injunction.

It seems that for a fraudulent debt bound by an IVA to survive its conclusion there would need to a specific term/condition in the IVA allowing for this. Schaw Miller appears to confirm this at [6.242] stating …'The terms of the arrangement will also determine whether or not the creditor's claim against the debtor is extinguished.' There is no such condition in the current protocol standard conditions.

In conclusion, it appears that a debtor's liability for fraudulent debts bound in an IVA will end once it is successfully concluded. That is unless there is a specific IVA term which states otherwise, or unless the creditor makes a successful legal challenge to their inclusion. Creditors who claim that they can pursue the remaining amount of an IVA debt following its conclusion without said term or court application under s262, simply because it was fraudulently incurred, should be challenged.