



Institute of Credit Management

# **Legal Proceedings and Insolvency Question Paper, Answers and Examiner's Comments**

Level 5 Diploma

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## **Legal Proceedings and Insolvency questions, answers and examiners' comments**

LEVEL 5 DIPLOMA IN CREDIT MANAGEMENT

**JANUARY 2013**

*Instructions to candidates*

Answer **COMPULSORY** questions 1 and 2 and any **THREE** other questions

All questions carry equal marks.

Time allowed: 3 hours

**You are reminded that, where appropriate, your answers should contain references to statutes and to case law.**

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### **COMPULSORY SECTION**

Answer **both** questions in this section

*Candidates appeared to prefer the questions relating to Legal Proceedings and Credit Control generally and these questions scored quite well. However, more attention to answering the question and observing the prescribed format for the answer would have seen candidates achieve much higher marks as most showed a good understanding of this subject area.*

*Disappointingly the insolvency part of the syllabus appeared to be less well understood and this significantly reduced the candidates' overall marks.*

1. a) Explain what is meant by the term insolvency. (2 marks)
- b) Give examples of **three** types of personal insolvency and **three** types of corporate insolvency. You should include in your answer the name given to the insolvency practitioner in each case. (3 marks)

MXBC Ltd owes your company £6,990 and the invoice is now 64 days past the due date. You reviewed the financial statements of MXBC Ltd and have noticed that turnover increased over the last 3 years, liabilities are stated as £26,400 with assets at £24,000. You are due to have a meeting with your credit manager and know that this account is on the list to be discussed.

### TASK

- c) i) Apply the information in your answer to a) and b) to the scenario above and advise if you consider MXBC Ltd to be solvent. (6 marks)
- ii) How does this affect your company? (3 marks)
- d) How can insolvency proceedings be used as a debt collection tool? (6 marks)

Total 20 marks

### Question aims

To test the candidate's knowledge of insolvency and in particular to distinguish between personal and corporate insolvency.

### Suggested answer

- a) A company is insolvent when it has more liabilities than assets on its balance sheet or it is unable to pay its debts when they fall due.

An individual is insolvent if he/she is unable to discharge his or her debts as they fall due.

### b) Personal Insolvency

- Bankruptcy *Trustee*
- Individual Voluntary Arrangement (IVA) *Nominee/Supervisor*
- Partnership Voluntary Arrangement (PVA) *Nominee/Supervisor*
- Debt Relief Orders *Official Receiver.*

### Corporate Insolvency

- Company Voluntary Arrangement (CVA) *Supervisor*
- Administration *Administrator*
- Administrative Receiver
- Creditors Voluntary Liquidation (CVL) *Supervisor*
- Compulsory Liquidation *Liquidator.*

- c) i) Liabilities exceed assets therefore the company is classed as insolvent. As turnover is on the increase it may be possible to trade out of the situation through a Company Voluntary Arrangement or Administration Order.

By entering into a CVA, the company would approach creditors with a proposal to pay a percentage amount against the outstanding debt for a period of time, i.e. 3 years. This is done to help them 'recover' the company.

An Administration Order is an alternative to liquidation for insolvent companies which would either:

- Bring about a more attractive realisation of assets for the benefit of creditors and members of the company

or

- Allow companies to trade through a period of insolvency (under proper supervision to protect the creditors) and return to profitability.

- ii) The relevance in relation to this question is that by trading through, there is a bigger chance of MXBC Ltd invoice being paid, maybe even in full.

However, by entering into either a CVA or an Administration Order, no action can be taken against the company by creditors as there is an automatic moratorium put in place to protect the debtor company.

A moratorium is whereby there is an order made preventing action being taken against the company.

- d) Insolvency proceedings can be used as a debt collection tool by making a demand against the debtor in the form of a Statutory Demand if the debt is over £750.

This is served personally on an individual but by post on a company.

The debtor has 21 days to respond, they can either pay or apply to set it aside.

If the demand is not met then the creditor may petition the court.

Answers should state that insolvency for debt recovery is not officially encouraged by the courts but is widely used.

*A disappointing response to this question given the impact on the collection of debts caused by insolvency and the relevance to the subject. Candidates scored low marks with only one managing to achieve 50%.*

*There is once again high misunderstanding between personal and corporate insolvency and this let the candidates down when marks were awarded.*

2. You are a credit controller at Hasmita Electrical Components Ltd. One of your customers has an overdue account that currently stands at £16,250. You have sent your standard chase letters and made several phone calls but despite promises to pay, the account remains unpaid. The customer trades from their registered office that is on the next street to your offices. You know they are still there as you walk past every morning on your way into work. You now want to progress this further and your credit manager has asked you to prepare a report.

### **TASK**

- a) Explain the legal process and your justification for the action you propose. (12 marks)
- b) Discuss what would happen if the customer was to defend the action. (8 marks)

Total 20 marks

### **Question aims**

This question is designed to test the candidates' knowledge of legal proceedings and apply that knowledge to a given situation.

### **Suggested answer**

- a) P - Pre-action protocol  
A - Application (for service of the claim)  
R - Response (debtor's response to the claim)  
A - Allocation (case tracking)  
D - Discovery (exchange of documents and information between the parties prior to hearing)  
I - In court Hearing  
S - Setting down judgment  
E - Enforcement.

You have followed the pre-action protocol, you know the customer is still trading and where they are. The customer has not raised any queries with the account. You therefore want to issue a claim form and commence recovery proceedings. This is done as follows:

Once the claim is issued the court will prepare a response pack giving the defendant the following options:

- Ignore the claim, do nothing
- Pay the amount due, including fees, interest and any scale costs
- Allege the debt has been paid
- Make an offer to pay
- Admit part of the debt and dispute the balance
- Defend (dispute) the claim
- Counterclaim, that is to make a claim against the claimant.

A defendant has 14 days from the date of service in which to exercise one of these options. However, if the defendant wishes to defend a claim, but needs longer than 14 days to prepare a defence, then he can complete a form of acknowledgement of service, indicating his intention to defend. The time for delivery of a defence in these circumstances is extended to 28 days from the date of service.

The acknowledgement of service however, must be returned within 14 days of service.

If there is no response to the claim within 14 days the claimant may apply for judgment in default.

b) **Defended Actions**

- Defendant may deliver a defence or a defence and counterclaim
- Pleadings must be verified by a statement of truth
- Counterclaim is when the defendant delivers a defence disputing the action and also brings a claim against the claimant
- Defences and counterclaims must be fully pleaded - set out the dispute and all the information relating to it
- Allocated to the multi track as over £15K
- 'Reply and defence' document used to set out the dispute
- Active Case Management by the court comes into effect
- Allocation questionnaire - allocate to the appropriate track, provide opportunity for settlement, monitor costs
- Transfer of case to defendant's local court.

*This question was better favoured by candidates with 70% obtaining more than 50% of available marks.*

## OPTIONS SECTION

### Answer three of the following questions

3. Motorbike spares and accessories business 'Mud and Polish Ltd' have recently received a very large rent bill from the landlords of the premises that they trade from. The rent has increased by 200% and an application to their bank to re-arrange overdraft facilities has been refused. The business has a full order book and is trading at a profit but this increase in rent is about to cripple them. Their bank holds a debenture over all assets.

### TASK

- a) What is a debenture? (6 marks)
- b) i) Explain Administrative Receivership to the directors of the company. (4 marks)
- ii) Advise if one of the above would be likely given their situation. (10 marks)

Total 20 marks

### Question aims

This question is designed to test the candidates' knowledge of insolvency and in particular to rescue packages.

### Suggested answer

- a) • A debenture is a security for a loan
- It usually gives a fixed or floating charge over the company's assets
  - Typically a bank or other financial institution is a debenture holder
  - If the terms of the debenture are not met then the holder can appoint a receiver
  - Triggers to appoint a receiver:
    - failure to pay on demand or the due date
    - failure to pay interest
    - execution against company goods
    - levying distress
    - creating a fixed charge over a company asset without the approval of the holder.
- b) i) S.29 IA defines an 'administrative receiver' as:
- A manager of the whole or most of the company's property who has been appointed by or on behalf of debenture holders holding security which includes a floating charge or
  - A person such as a receiver or manager but for the appointment of some other person as receiver of part of the company's property
  - Available to fixed or floating charge holders when a company has defaulted on the terms under a debenture.
- ii) Yes, it is likely that the bank would apply to appoint an Administrative Receiver, as there is little or no prospect of the company improving its position under current management structure.

Appointed to achieve one of the following:

- To continue the business as a going concern with a view to either selling it or retuning it to profitability
- To continue part of the business which is profitable but disposing of other parts of the business
- To wind down the business by completing current orders, maximising income and then disposing of assets.
- Administrative Receiver takes custody & control of all assets charged under the terms of the debenture.
- If an Administrative Receiver is appointed under s.29 Insolvency Act 1986 control of the business and assets passes upon acceptance of the appointment.
- Administrative Receiver must always be a licensed insolvency practitioner.

*Not one candidate attempted this question.*

4. Mr Murfinson is a director of TPLM Ltd a company that sells goods by mail order. They accept credit card payments over the telephone and have a system whereby credit card details are recorded on a form and then attached to the order. All orders and payments are processed at the end of the day. The forms are then passed to Mr Murfinson for shredding.

The purchase ledger clerk notices that many delivery notes are being matched with invoices that state 'paid' but can find no trace of payments in the company bank account. TPLM are experiencing serious cash flow problems and have not paid suppliers for several months.

After further investigation it appears that Mr Murfinson has been using the details of TPLM's customers' credit cards to make purchases for the business before shredding the forms.

### **TASK**

Apply what you know about the Insolvency Act, Companies Act and Company Directors Disqualification Act to the above scenario to advise on the situation.

Total 20 marks

### **Question aims**

This question is designed to test the candidates' knowledge of insolvency and legal proceedings with particular attention to director's disqualification.

### **Suggested answer**

#### **Cork**

Discourage and punish directors guilty of breaches, criminal and civil offences/remedies offences of misconduct in connection with insolvency and fraud Insolvency Act 1986 & Companies Act 2006 criminal sanctions of up to 7 years imprisonment / unlimited fines.

#### **Insolvency Act 1986 Offences**

- Concealment of company property
- Concealing, destroying or falsifying company books or documents
- Disposing of goods bought on credit not yet paid for
- Disposing of company property by gift, transfer or charge
- Concealing or removing property belonging to the company 2 months before the date of any unsatisfied judgement or order for payment
- Failure to disclose all property belonging to the company to the liquidator
- Failure to deliver up the company books
- Destroying or falsifying books, papers or securities of the company
- Making any material omission from statements of the company affairs
- Making false representations or committing any other fraud for the purpose of obtaining the consent of creditors to any agreement.

### **Companies Act 2006 Offences**

It is an offence to carry on any business with the intent to defraud creditors or for any fraudulent purpose s.993.

### **Directors Defences**

Companies Act 1985 s.458 - must require fraudulent intent.

### **Insolvency Act remedies**

In addition to criminal proceedings under the Insolvency Act 1986 directors may be liable to civil proceedings to compensate creditors who have lost out as a result of the directors' conduct.

S.212 allows application to the court when it appears the director has:

- misapplied or retained company property
- been guilty of misfeasance
- breached any duty owed to the company.

\*s.214 contributes to assess

Court can order the director to return the property, repay any money taken or pay compensation.

### **Company Directors Disqualification Act 1986**

- Gives power to the court to make an order \*s.10 that disqualifies a director for up to 15 years \*s.4
- Disqualification Undertaking with the Secretary of State - effective from April 2001
- An order without costly court action

Orders / Undertakings can be made for a max of 15 years and disqualify directors from

- Acting as a director of a company
- Acting as an insolvency practitioner
- Directly or indirectly being concerned in the promotion, formation or management of a company.

4 main situations for making a disqualification order

- Misconduct
- Default in filing documents
- Fraud
- Unfitness.

In the situation above the director would be guilty of fraud.

### **Under the Insolvency Act**

- Concealing, destroying company books or documents
- Destroying and falsifying books, papers or securities of the company.

The director can be called upon to return the property, repay any money taken or pay compensation.

**Under the Company's Act**

It is an offence to carry on a business with the intent to defraud creditors for any fraudulent purpose.

**Under Directors Offences**

As ~~s.458~~ must require fraudulent intent. \*repealed s.993

Good answers will note that this director would most likely be sent to prison given the seriousness of what s/he has done.

Note:

Credit will be given for answers referring to both the Companies Act 1985 and 2006.

*Only 30% of candidates attempted this question and gained very poor marks.*

*The question allowed the candidate pretty much a free reign to write what they knew about insolvency and legal proceedings with particular attention to directors' disqualification. The response was sadly lacking and showed little knowledge of the subject.*

5. You have recently joined Jupta Ltd as pre-legal credit controller and have been reviewing all outstanding debts at least 90 days over their payment terms. Your company credit terms are 30 days. One debt in particular for £8,250 is causing concern, and it doesn't appear to have been chased for payment at all. Given the age and amount of the debt your finance director wants to issue a County Court claim form.

### TASK

- a) Advise your finance director regarding the action he wants to take and suggest what course of action should be followed in this instance **before** a claim form can be issued. (12 marks)
- b) What changes to current procedures would you recommend to your finance director? (8 marks)

Total 20 marks

### Question aims

This question is designed to test the candidates' knowledge of legal proceedings in particular in relation to pre action protocol.

### Suggested answer

- a)
- Unable to issue a claim form until the customer has been given the opportunity to pay the invoice
  - Not complied with any of the required Pre-action protocol.
  - Need to make contact with the customer
  - Check you have the correct address
  - Ensure they have the invoice
  - Check there are no disputes/queries that need resolving
  - As the customer is a company if not paid then you can issue a 7 day letter before action.

If no response to the 7 day letter then you can issue a claim form.

- b) Introduce a collection procedure that complies with pre action protocol

C Collection  
R Resolution  
I Identity  
M Means  
E Evidence.

*100% of candidates attempted this question with some good marks when viewed against the paper as a whole with most candidates obtaining around the 50% mark.*

*Candidates could make easy marks by applying their knowledge to answering the question rather than just writing down what they know about the subject.*

6. 'Walking Sticks' country and outdoor leisure store is partnership owned and run by two brothers, Bobby and Billy Sticks, who have fallen out. They can no longer work together and the business is in a dire state. Bobby Sticks has a son who runs a similar type of store and Bobby has been letting him have stock at an extremely reduced price.

### TASK

- a) Describe what is meant by the following and give examples of each:
- Set off
  - Antecedent transactions
  - Transactions at an undervalue
  - Onerous property. (14 marks)
- b) Billy Sticks is concerned about what is happening with the stock.
- i) Explain in a letter to Billy what may be required of Bobby's son should the partners be subject to insolvency proceedings. (4 marks)
- ii) What can Billy do to protect his stock in the meantime? (2 marks)

Total 20 marks

### Question aims

This question is designed to test the candidate's knowledge of insolvency with particular attention to reversal of transactions following transactions at an undervalue.

### Suggested answer

- a) **Set Off**
- Mutual debts contra'd or set off between the two companies
  - Contained in rule 4.90 Insolvency Rules.

### Antecedent Transactions

- Transactions entered into by insolvent debtor before bankruptcy / winding up order
- Effect of considerably reducing the value of assets available for distribution
- Sell assets to a relative or associated company for a reduced value
- Pay certain creditors (prefer) over others.

### Main types are:

- Transactions at an undervalue
- Preferences.

### Transactions at an undervalue

Entered into by the debtor

- Within a relevant time before the onset of insolvency and
- At an undervalue - less than the full value at the time of the transaction.

Relevant Time Limits apply

Type of antecedent transaction	Insolvency Act 1986 section	Insolvency Act 1986 time limit section	Relevant time
Undervalue	Individual s.339	341 (1)	5 years
Undervalue	Corporate s.238	240 (1)	2 years
Preference	Individual s.340	341 (1)	6 months *
Preference	Corporate s.239	240 (1)	6 months
Extortionate Credit transaction	Individual s.343	343	3 years
Extortionate Credit transaction	Corporate s.244	244	3 years

\*This period extends to two years where preferred creditor is an associate of the debtor.

**Onerous property**

- Disclaim property that would not be in the best interests of creditors to retain.
- Trustees, liquidators etc have right to disclaim property
- Procedure is via the courts.

**b) Reversal of transactions**

- i) Court may make an order to restore the position to what it would have been had the transaction not been entered into. The court has power to:
  - Require property to be returned by the third party to the trustee or liquidator
  - Order the third part to pay money to the estate to represent the benefit received (ss.241 and 342 Insolvency Act 1986).
- ii) Prior to winding up, Billy can apply for an injunction, the obvious one being a freezing order which will typically restrain Bobby dealing with or disposing of any assets/property belonging to the partnership and located within the jurisdiction of the court.

*A question that was attempted by the majority of candidates, some with above average marks.*

*Candidates were confused over who they were offering the advice to. This could have been avoided had candidates taken time to read the question more closely before attempting their answer.*

7. You are a credit controller for SxD Ltd and your customer In Glass Ltd owes you £15,000 in overdue invoices. You have recently obtained a charge on their factory premises and now there are rumours that In Glass Ltd is in trouble. Your financial controller wants some information regarding the charge your company holds and what, if any, effect that will have for SxD Ltd if winding up proceedings are commenced against In Glass Ltd.

### TASK

- a) State the priority of creditors in a winding up petition. (6 marks)
- b) What is meant by the term 'ring fenced funds'? (4 marks)
- c) What is the pari passu principle? (4 marks)
- d) Prepare a report for your financial controller, applying the principles in a) to c) to the situation SxD find themselves in. (6 marks)

Total 20 marks

### Question aims

This question is designed to test the candidates' knowledge of insolvency and in particular to the priority of creditors.

### Suggested answer

- a) Pre determined order; some creditors have higher priority due to type of debt they hold:
- Priority insolvency expenses
  - Secured creditors
  - Expenses of the insolvency
  - Preferential debts (wages, accrued holiday pay)
  - Floating charges
  - Ordinary debts
  - Interest on preferential and ordinary debts
  - Deferred debts plus interest thereon.
- b) Ring fenced funds (prescribed funds) - a proportion of funds available to floating charge holders made available to unsecured creditors.

Prescribed minimum £10,000

Prescribed part 50 % of first £10,000  
20% thereafter to a  
Maximum of £600,000

Proportions can be amended by the Secretary of State.

- c) Creditors are paid equally within their credit class or equally in proportion to their debts if there are insufficient assets to meet all debts in that particular class.
- d) SDX Ltd rank as a normal creditor as ring fenced funds are not applicable in this case, these are only applicable to floating charge holders.

Although as a charge holder they will have higher priority as money from the sale of fixed charge assets is paid to the secured creditor after the costs and fees of the receiver in collecting this money have been paid, secured creditors cannot 'prove' for their debts in an insolvency unless they waiver their rights to security.

If the asset realises less than the amount of the charge then the secured creditor has several options to:

- prove for the balance as an ordinary creditor
- 'value' the security and prove for the balance
- surrender the security and prove for the full amount.

Paru Passi Principle states that each creditor is paid equally within their class and paid as a normal creditor, so in our scenario irrespective of the charge, this would apply to us.

To summarise, the best result would be to apply for an order for sale, however, it is worth noting that, if an order for sale proceeds, and insufficient funds are realised, then the creditor is liable to pay off all prior charges.

*A popular question with candidates however, candidates that attempted this were not fully conversant in all areas of the question and whilst they scored high marks for areas they knew in detail, they were let down by the lack of knowledge in other areas.*

8. As a member of the consumer credit control team you have issued a small claim for £5,000 to Peter Piper for failure to pay for goods delivered and invoiced two months ago.

A defence has been received claiming that the goods are faulty and not fit for purpose. No notice was received following delivery of the goods and your technical director does not believe that the goods are faulty.

Allocation questionnaires have been filed and the District Judge has referred the case for mediation.

### **TASK**

- a) Prepare a memo to your credit manager to include the following:
- An outline of the mediation procedure
  - The advantages and disadvantages of mediation
  - An explanation of when a court hearing is preferable to mediation
  - Advice on whether mediation should be accepted given the information above. (16 marks)
- b) What is a Tomlin Order and how could it apply in this case? (4 marks)

Total 20 marks

### **Question aims**

This question is designed to test the candidates' knowledge of legal proceedings in relation to mediation.

### **Suggested answer**

#### **Small claims mediation procedure**

- Small claims allocation questionnaire
- Allocation questionnaire returned to court
- Judicial consideration of papers
- Court staff notify mediator
- Parties contact mediator - if agreed parties are sent an agreement to mediate
- Mediation
- Outcome of mediation.

#### **Advantages**

- Cheaper than a hearing
- No need to attend court
- If both parties willing will often get a better result.

**Disadvantages**

- If one or both parties unwilling unlikely to succeed
- Not suitable for all types of cases.

**Court hearing is preferable when:**

- A precedent is required
- Earlier mediation has failed
- Public decision desired
- Imbalance of power
- Cultural background
- When only a court ruling can bring around a solution.

In this case mediation should be accepted.

- b) A Tomlin order is a court order under which a court action is stayed, on terms which have been agreed in advance between the parties and which are included in a schedule to the order.

It is used in this instance to allow for mediation.

Good answers will also mention that a further order is needed before the terms of the schedule can be enforced.

*Only one candidate attempted this question with obviously little knowledge of the subject area, thus scoring very low marks.*

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