Julian Dobson SOLICITORS

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NEWSLETTER

Preferences and where to find them

Introduction

Although the statutory provisions for preferences have been around for many years, the number of reported decisions remains low. Previous funding difficulties have been eased and office holders may now assign the pursuit of such claims to third parties. In many cases preference claims have been settled. An effect of the COVID-19 pandemic has been the extreme financial pressure on companies and their directors. The addition of unprecedented levels of government funding has resulted in perfect conditions for a Preference bloom.

What is a Preference?

A preference under **Section 239** of the **Insolvency Act 1986** is where a company does or suffers something to be done which places a creditor, surety or guarantor of a company in a better position in the event of the company going into insolvent liquidation than if that thing had not been done

Conditions required for a Preference

1. Relevant Time and the Onset of insolvency

To establish a preference by a company, the transaction must have taken place at a relevant time. In the case of a transaction with a person who is not "connected" to the company there is a time limit of six months ending with the "onset of insolvency".

In a creditors' voluntary liquidation this would be the date of the resolution to wind-up. In a compulsory liquidation it will be the date on which the petition was presented to the court.

In administration the onset of insolvency is either the date on which an application is made for an administration order or the date on which the notice of intention to appoint is filed.

In the case of a transaction with a connected party or "associate" the time period is extended to two years. The technical definitions of connected and associates are contained in **Sections 249** and **435** of the **Insolvency Act 1986**.

2. Influenced by a desire

To successfully challenge a transaction as a preference, it is also necessary to establish that the company was "influenced by a desire" to improve the position of the person in an insolvent liquidation.

Unconnected parties

Where the person is not a connected party, establishing that the company was influenced by a "desire" can be difficult, particularly where there may be a number of possible explanations for the transaction. To establish that a company was influenced by a desire it is necessary to consider the actions of the human beings involved and in particular their role/status in relation to the company. Whilst usually authority will be delegated to directors in which case their knowledge and intentions will be easier to attribute to the company the situation is more difficult in the case of transactions involving the decisions of managers or employees.

For unconnected parties, in order to establish a preference it will be necessary to show that the desire to benefit the creditor, surety or guarantee was the motivating factor. This means that a good alternative explanation will often successfully displace the assertion that the company had the necessary desire. Such reasons can include the provision of a further finance facility or continued supplies. Similarly, genuine creditor pressure will mean that the desire to put the creditor in a better position will not be made out. Other examples include a desire to save the

Preferences and where to find them

business. In the case of **Re Lewis's of Leicester Limited [1995] BCC 514** the company rented out small units in a large department store. Aware of financial difficulties, it set up a trust in respect of receipts made by the company on behalf of the small retailers. In that case the allegation that the trust operated as a preference was defeated on the basis that the company had been motivated by the wish to retain the business of the small retailers over the Christmas period. In a bankruptcy case **Re Hardwick [2002] BPIR 947**, a family friend paid off the bank releasing its security enabling them to take a transfer of the properties. In that case the bank's threats to foreclose were held to be the motivating factor and not a desire to put the family friend into a better position than would otherwise have been the case in event of insolvency. Successfully establishing a preference against a non-connected party can be difficult and requires detailed investigation.

Connected parties

The office holder's task of establishing that the company was influenced by a desire is made easier in the case of connected parties where a presumption arises and the necessary desire is presumed **(Section 239(6)** of the **Insolvency Act 1986)**.

In the case of connected parties the effect of the presumption will be that the defendant will need to provide an alternative explanation for the transaction demonstrating proper commercial reasons to rebutt the presumption.

3. **Insolvency**

   In order to be a relevant time for the purpose of establishing a preference, it is also necessary for the company to have been unable to pay its debts at the time or as a consequence of the preference. Insolvency is defined in **Section 123** of the **Insolvency Act 1986**. In seeking to establish whether a company is unable to pay its debts as they fall due the existence of unpaid invoices and creditor pressure will be relevant factors both on the question of insolvency and the existence of the necessary desire. When applying the insolvency test, this should reflect the commercial realities facing the company as was made apparent in the case of **BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL plc [2013] UKSC 28**.

Why the sudden interest?

The COVID-19 pandemic has seen financial intervention by government at a rate not previously seen in peacetime. As at 13 December 2020 the figures were as follows:

Coronavirus Business Interruption Loan Scheme (CBILS) (excluding large businesses)	£19 Billion
Bounce Back Loan Scheme (BBLS)	£43 Billion

The potential for insolvent businesses to use these loans to make preferential payments is huge. In addition to this there has been evidence of substantial fraud. Guidance has recently been released in Dear IP December 2020 to practitioners concerning suspicious or fraudulent redundancy claims. HMRC aided by new powers under the Finance Act 2020 are also seeking to make recoveries against directors who have abused any of the coronavirus support schemes. Insolvency practitioners will be expected by HMRC and creditors to investigate abuse of government funding and the making of preferential payments.

3

Preferences and where to find them

Preferences and where to find them

1. Bounce Back Loans

Bounce back loans have formed a significant part of the support given to companies. The loans have been available with minimum requirements needing to be satisfied and without the need to provide security in the form of guarantees. In some cases bounce back loans have been used to repay existing borrowings with the consequence that directors' personal guarantees have also been released. Directors in those circumstances will need to provide a credible explanation as to why the presumption that the company in repaying the borrowing and allowing personal guarantees to be released, did not desire that the director should be placed in a better position in the event of insolvent liquidation. Directors in such circumstances may also face breach of duty claims and/or misfeasance arising out of preferential transactions

2. Trade Suppliers

A more subtle form of preference will be the paying of trade suppliers possibly with a view to maintaining relationships post-liquidation. This will require a detailed analysis of how and when creditors are paid. For example, this occurred in the case of **Re Gemma Limited [2008] EWHC 546 (Ch)** where trade creditors were paid at the expense of the company solicitors who had acted for the company in litigation. The director was found to be conferring on trade creditors a preference for future business support for his new business venture and was ordered under **Section 239** to repay the amounts paid to creditors.

3. Friends and Family

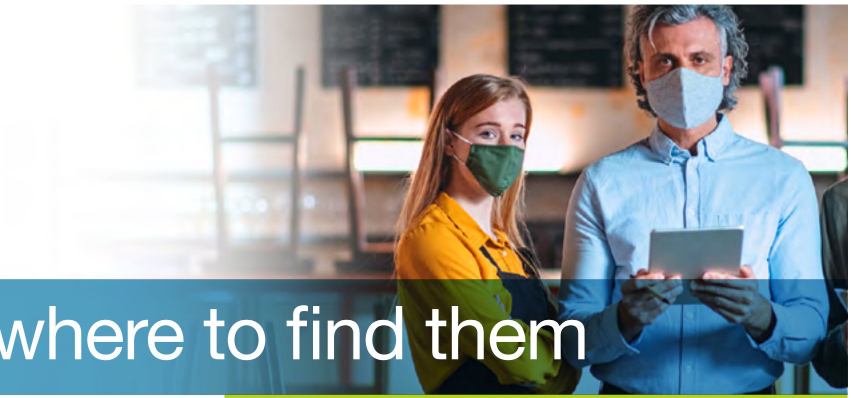
Payments to family members in the twilight period will often be preferential and relatively easy to establish as they are connected parties. Friends otherwise unconnected with the company will be more difficult to challenge where they have received alleged preferential payments.

4. Granting of Security

Where a company grants security to an existing creditor in respect of a debt owed to it a preference may arise if security is given in respect of existing debt. Careful consideration will need to be given to the motivating factors in granting the security in order to establish the necessary desire to improve the creditor's position.

5. The Giving of Guarantees

Where a creditor of a company is given a guarantee by another party i.e, a holding company, a third party or director, this may also amount to a preference. This is because the company "suffers" something to be done in allowing the guarantee to be given which improves the creditor's position.



Preferences and where to find them

Conclusion

Directors of companies receiving Government assistance in the form of Bounce Back Loans and other funding should take special care in how those funds are used and record the circumstances and motivating factors behind the making of any payments from those funds that may constitute a preference.

Insolvency practitioners will be expected to look closely at the way in which Government funding has been applied by companies in the twilight zone in order to identify any preferences as well as fraudulent activity. Whilst Government has been quick to provide emergency funding to companies during the pandemic, it will also in the recovery phase be keen to ensure that all agents, including insolvency practitioners actively pursue recoveries from both fraud and preferences.

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