



Specialist Debt Advice Service

Spotlight

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A Practical Guide to Preferences and Debt Relief Orders

This Spotlight will address the practical considerations debt advisers need to make when considering whether they need to report that a preference has been paid, and what the likely outcome of this will be.

The law

[Schedule 4ZA](#) of the Insolvency Act 1986 (IA 1986) provides the conditions for making a DRO. Paras 1 to 8 stipulate the mandatory grounds and para 9 (undervalue transactions) and para 10 (preferences) provide grounds where the Official Receiver (OR) has discretion as to whether to accept or decline an application.

Para 10 states:

“(1) The debtor has not given a preference to any person during the period between—

(a) the start of the period of two years ending with the application date; and

(b) the determination date.

(2) For this purpose a debtor gives a preference to a person if—

(a) that person is one of the debtor's creditors to whom a qualifying debt is owed or is a surety or guarantor for any such debt, and

(b)the debtor does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event that a debt relief order is made in relation to the debtor, will be better than the position he would have been in if that thing had not been done."

A few things to note here:

- The OR can only look back over the two years prior to the application. Where there is a strong chance the application may be declined as a result of a preference it may be appropriate to consider delaying the application.
- A preference can only be paid in respect of a qualifying debt. Qualifying debts are defined at [s251A IA 1986](#). Most notably, therefore, a preference cannot be paid in respect of an excluded debt – these are defined at [Rule 9.2](#) of The Insolvency (England and Wales) Rules 2016. Also, a preference cannot be paid if the debt is not payable immediately or at some certain future time and therefore, this would seem to rule out preferences being paid in respect of unenforceable loan shark debts, time-barred debts or otherwise unenforceable debts. However, it may be necessary to consider whether an undervalue transaction has been paid in these circumstances.
- Payments by third parties, from their own funds, made directly to creditors would not be considered to be preferences.

It should also be noted that the IA 1986 provides no steer to the OR with regard to the factors it should consider when deciding whether to accept or decline an application in light of any preference/s that have been paid.

A brief comparison with preferences in bankruptcy

In bankruptcy, the law on preferences operates largely to enable the bankruptcy trustee to recover monies that have been paid as preferences for the bankruptcy estate. In contrast, there are no provisions for the OR to attempt such recoveries after a DRO has been made – the only issue is whether or not a DRO should be made in light of any preference/s that have been paid.

There are similarities between the definition of a preference in bankruptcy (at [s340 IA 1986](#)) and the DRO definition, but they are not the same. One important difference is that, in bankruptcy, there is a requirement that the person paying the preference was influenced by a desire to put the person to whom the payment was made in a better

position than they would have been, in the event of bankruptcy – they had an ‘intention’ to prefer.

Whilst ‘intention’ is not a factor in determining whether or not a preference has been paid in relation to a DRO, it is likely to be the most important factor for the OR in determining whether the application should be accepted or declined.

Preferences were the third most common reason why DRO applications were refused in 2020/21.

The two-stage test

When considering preferences in relation to DROs it can be helpful to apply a two-stage test:

- 1. *Has a preference been paid and does it need to be reported?***
- 2. *Is it likely the DRO application will be declined as a result of the preference and what information/evidence might the client submit to reduce the chances of this?***

Let’s consider these two stages in turn.

1. Has a preference been paid and does it need to be reported

This should, as far as possible, be an objective test, with reference being made to the definition at para 10 of Schedule 4ZA (see above) and any specific guidance that has been provided by the OR.

There’s a sense in which it’s difficult to conceive of a case where, if we apply the definition in Schedule 4ZA strictly, a preference hasn’t been paid. A client would have been having to make strict pro-rata payments to all their creditors in the two years prior to the application for you to unhesitatingly pass over the question on the application form. However, it seems clear from the specific guidance that has been offered by the OR, and general practice, that a degree of judgement on the part of the Approved Intermediary (AI) is required here. Were the test to be applied in a strict, absolute sense, every DRO application would require further examination and the current system of largely automated processing of applications could not be sustained.

Therefore, the starting point will be to consider the possible preference against the law and any specific guidance that has been published. After that it will be a case of making a professional judgement. The OR will not, generally, advise in relation to

specific cases. We are often asked about whether particular payment/s need to be reported as preferences and we can advise on any legal issues involved, but it is ultimately the AI's call as to whether the payment/s need to be reported as preferences.

This is not a judgement that many debt advisers are comfortable in making and is one of several ways in which being an AI compromises their independent role as an advocate for their clients. Advisers should consider making their role as an AI clear to their client before entering any discussion about their debts – they can't 'untell' you something that they may not have disclosed had they been aware that you would subsequently have to disclose this to the OR in connection with a DRO application.

It is, perhaps, the need for the AI to exercise this judgement at the first stage that often leads to the two separate tests being conflated into one.

The OR has advised that if an AI is in doubt about reporting a preference they should report it and our advice on specific cases will tend to be cautious in this regard. You may wish to bear this in mind before contacting us.

Where a preference is being reported on the application, it will be appropriate to advise the client there is a risk the application will be declined and that they will lose their £90 application fee.

2. Is it likely the DRO application will be declined as a result of the preference?

Whilst, as discussed above, the 'intention' to prefer is not part of the definition of a preference in relation to DROs, it is likely to be a crucially important factor for the OR, in determining whether the application should be accepted or declined. Indeed, where a DRO application is declined because of a preference, this is most frequently where the preference has been paid to a friend or relative.

There are a number of other factors the OR will consider and the [DRO Guidance for Advisers](#) suggests the following:

- *whether the debtor was insolvent when they made the payments*
- *why they made the payments*
- *who they made the payments to*
- *what date they made the payments and how much they paid*
- *whether there was any agreement drawn up for the payments*
- *why the debtor did not distribute the funds to all of their creditors evenly*
- *whether there was any creditor pressure*
- *whether a preference has been made to an associate (like a relative)*

- *whether there is any evidence that the funds repaid were owed*
- *how the debtor got the funds they needed to make the payments*

Any evidence that can be supplied with the application, or in a preceding email, positively addressing these points, may help to improve the chances of the application being accepted.

Debt Relief Restrictions Undertakings and Orders (DRRU/Os)

Where preference/s have been identified, depending on the details, it may be necessary to consider whether this might lead the OR to consider whether a DRRU/O is appropriate.

These are provided for by [Schedule 4ZB](#) IA 1986 and may be considered where the client has acted dishonestly or irresponsibly and can extend the period over which the DRO restrictions apply for up to fifteen years.

Further information

[Debt Relief Orders: guidance for debt advisers](#)

[Citizens Advice DRO Toolkit](#) – this is available to organisations who are not part of Citizens Advice via [WiserAdviser](#) though prior registration and login is required.

CPAG Debt Advice Handbook (also available free [online](#))