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Insolvency Alert
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Unfair preferences and section 588FA of the Corporations Act - is the 'ultimate effect' of the 'entire transaction' relevant?

The recent decision of the Court of Appeal of the Supreme Court of Victoria in McKern & Ors (as liquidators of Centaur Mining & Exploration Limited and Centaur Nickel Pty Ltd) v The Minister Administering the Mining Act 1978 (WA) [2010] VSCA 140 ('Centaur Mining') has brought into focus the application of the 'doctrine of ultimate effect' to unfair preference claims brought by liquidators under s 588FA of the Corporations Act 2001 (Cth) (the 'Act').

About Section 588FA and the doctrine of ultimate effect

Section 588FA of the Act was introduced by the Corporate Law Reform Act 1992 (Cth) (the '1992 Act'), and provides that a transaction is an unfair preference 'if, and only if' the creditor has received more than it would receive if the transaction were set aside, and the creditor were to prove, in a winding up (subject to the exception in relation to running accounts, see s588FA(3)).

Prior to the 1992 Act, the Courts applied the doctrine of ultimate effect, which dictates that a Court must look at the 'ultimate effect' of the 'entire transaction' in deciding whether a transaction is an unfair preference.

The result of applying the doctrine was that where payments under challenge were made in order to 'induce the creditor to provide further goods or services as well as to discharge an existing indebtedness', then such payments were not regarded as preferential (Air Services Australia v Ferrier (1996) 135 FLR 423). The doctrine did not apply where a payment was made only to discharge an existing debt.

History of the Courts applying the doctrine

The doctrine was applied in Re Discovery Books Pty Ltd (1973) 20 FLR 470, a case in which rental payments to the landlord of the company's business premises were alleged to be unfair preferences. In what came to be known as the 'landlord's defence', the rental payments were held not to be unfair preferences.

The Court held that it was bound to consider not just the payments themselves and the corresponding discharge of debt, but the benefit to the company as a whole, which in that case was the ability of the company to continue trading from the premises.

The Victorian Court of Appeal in VR Dye & Co v Peninsula Hotels Pty Ltd [1999] 3 VR 201 ruled that the doctrine of ultimate effect had survived the 1992 Act, such that in order to prove an unfair preference, a liquidator was required to:

(i) show that the creditor had received more than it otherwise would in a winding up (as specifically required by s588FA), and

(ii) defeat any attempt by the creditor to argue the landlord's defence.

This approach was followed by the NSW Court of Appeal in Beveridge v Whitton [2001] NSWCA 6.

The Queensland Court of Appeal in Sheldrake v Paltoglou [2006] QCA 52, however, ruled that the doctrine of ultimate effect was relevant only to the law prior to the 1992 Act and was not applicable to the operation of s 588FA.

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Centaur Mining

The claim in Centaur Mining was brought by the liquidators of Centaur Mining and Exploration Ltd, to recover rent and royalty payments made to the Minister administering the Mining Act 1978 (WA) in respect of certain mining tenements.

The Minister argued that these payments could not be unfair preferences because, applying the doctrine of ultimate effect, the value to the company of being able to continue to utilise the mining tenements exceeded the value of the payments to the Minister. Conversely, the liquidators submitted that the doctrine of ultimate effect and the landlord's defence were not applicable to a claim made pursuant to the provisions introduced by the 1992 Act.

In doing so, it considered that the 1992 Act 'was not intended to change the basic structure of voidable preference law' by abandoning the doctrine of ultimate effect and leaving s588FA to stand on its own. Further, the Court specifically expressed doubt over the reasoning applied by the Queensland Court of Appeal in Sheldrake.

Despite the Court finding that the doctrine of ultimate effect did survive the 1992 Act and therefore that the payments of rent were not unfair preferences, the liquidators succeeded in arguing that the doctrine did not apply to royalty payments. The Court agreed with the liquidators that royalties 'were paid in arrears and thus in satisfaction of existing debts', and so were not protected by the doctrine.

Referral to the High Court likely

The Court also noted that in Beveridge the NSW Court of Appeal had followed VR Dye, and further noted the importance of 'intermediate appellate courts following each other in the interpretation of national legislation'. Given the Queensland Court of Appeal had taken the opposite view in Sheldrake, it is not surprising that Nettle JA went on to say 'If the reasoning in VR Dye is to be overturned, it is for the High Court to say so.' Put simply, watch this space.

What does this mean for insolvency practitioners?

It appears likely that the issue of the applicability of the doctrine of ultimate effect will be referred to the High Court. Until then insolvency practitioners should, in addition to assessing whether a creditor has received more than it otherwise would have in a winding up, consider whether the relevant payments:

1. were made to secure the continuing provision of goods or services (and not just to discharge a past debt); and
2. could be said to benefit the company as a whole, such that creditors have not been adversely effected.

The question of whether the doctrine applies in Queensland, by virtue of the decision handed down in Sheldrake, is undecided. While the Queensland Court of Appeal has determined that the doctrine does not apply, any court exercising Federal jurisdiction in Queensland will have competing authorities to consider.

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