

Directors' Duties - A Court Assesses Business Risk

By Philippa Fee

Being in business is all about taking risks, we are told. Evaluating those risks and deciding how to manage them so as to minimise the chance of business failure is a skill that few judges would claim to possess. But the court in *Goatlands Limited (In Liquidation) v Parsons & Kenealy*¹ not only analysed those risks, but more surprisingly formulated a percentage of risk which was unacceptable for a director to run.

The Facts

For some years the Borrells farmed goats in the Waikato on two blocks of land. They began a subdivision of the two blocks into five smaller blocks. In May 2001 the Borrells decided to shift the farming operation to a new property in Horotiu which was better suited to their needs and they entered into an unconditional contract to purchase it. They had a year to complete the purchase, during which time the Borrells needed to sell one of the larger blocks to fund the purchase of the new farm.

Goatlands, the company established by the Borrells as the land-owning company, applied for a GST refund on the full purchase price of the Horotiu farm – something they were quite entitled to do, even though they had not settled the purchase. The GST refund was spent on the deposit and the construction of buildings on the property.

Unfortunately the Borrells were unable to sell any of the blocks of land in the year before settlement was due and so defaulted on the purchase. The owner of the new farm cancelled the contract. The IRD sought repayment of the GST and Goatlands went into liquidation when it could not repay the money. The IRD then began a proceeding against the Borrells alleging that:

- The Borrells had caused the Goatlands' business to be carried on in a manner which was likely to create a substantial risk of serious loss to creditors (s135); and/or
- The Borrells caused Goatlands to incur a contingent obligation to repay the GST when the Borrells had no reasonable grounds to believe that Goatlands would be able to repay it (s136).

Substantial Risk

The heart of the issue was whether the Borrells took an unacceptable risk in accepting the GST money when Goatlands' ability to repay it turned on the chance of selling the blocks of land. The crux of s135 is the proper interpretation of "substantial risk". The court said that where directors are considering whether the company should enter into a single transaction that has the potential to cause its complete demise, they must reach their decision after "sober assessment" of the level of risk that the transaction entailed for the company and its creditors. They should only proceed to commit the company to the transaction if, objectively viewed, the risk of failure is sufficiently small to warrant the company taking it.

How small a risk is sufficiently small?

The Borrells' ability to fund the purchase of the new farm turned on the probability of one of the large blocks selling in that one year. While it may seem unbelievable to us now, given New Zealand's recent property boom, after the Borrells signed the agreement the rural property market in the Waikato area went flat and the Borrells could not sell even one of the blocks during that year.

The Borrells gave evidence that at the time they signed the purchase agreement they assessed the risk as being five percent. In coming to this view, they relied on the advice of a real estate agent that the property market was buoyant. Their solicitor gave them advice at the time was that the risks were manageable.

There were a number of other problems the Borrells were experiencing in their goat farming business which meant that they were under considerable pressure to proceed.

¹CIV 2005-419-1643, Unreported High Court, Hamilton, 14 December 2006)



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The court said that in reality Mr & Mrs Borrell were not in a position to make a considered decision to purchase the Horotiu property. While they purportedly took advice from others, “their hands were effectively tied”.

The court said that the principal risk arose from the fact that the real estate market is as vulnerable to upward and downward swings as any other commodity market. It is impossible to predict in advance whether, and to what extent, a swing either way is likely to occur, or how long a downturn will last.

The noticeable feature of the court’s decision is that the judge ascribed a particular percentage to the risk of failure. The court rejected the Borrells’ 5% risk assessment and said the risk was in fact 25%. While recognising that the assessment was “approximate” the court then found that a risk of that size was substantial and should not have been run. In the context of the s135 claim, the court found that Mr & Mrs Borrell did not have reasonable grounds to believe they would achieve a sale of one of the larger blocks in time to enable Goatlands to settle the purchase.

Reliance on Experts

The judge found that the Borrells were not entitled to place reliance on the advice of the real estate agent, so that the defence in section 137 was not made out. No reasonable person in the position of the Borrells would have relied on the agent as providing any guarantee or assurance that the blocks would sell. So far as the solicitor’s advice is concerned at most he identified the risks and said that in his opinion they were manageable. The judge said that his advice did not address the problem of what the Borrells should do if the sections did not sell. The advice was also outside his expertise.

Comment

This decision is significant for a number of reasons.

The court regarded its function as the ascribing of a particular percentage chance to the risk of failure eventuating.

The Borrells’ assessment of the chance of failure (5%) was rejected in favour of the court’s assessment of 25%. But on what basis was this assessment made? No expert evidence from those qualified to assess business risk was given to the court. All there appears to have been is the Borrells’ own subjective judgment, with which the judge disagreed. If there was a methodology underpinning the assessment, it does not appear in the decision. The judge noted the various factors to take into account in assessing risk, but the leap from that to a particular percentage was not explained.

How real is it that the courts try to make such assessments in any event? As Lang J recognised in *Goatlands*, his figure was only an approximation. But by ascribing an exact percentage to what is only an approximation it ends up looking like something else.

Finally, if one accepts the 25% chance of failure ascribed by the court, then surely the flip side is that the Borrells had 75% chance of success? Such a significantly better than even chance of success might be regarded by a businessman as a reasonable basis for deciding on a course of action.

Given this, the Borrells would be justified in thinking not only that they were unlucky in the timing of their investment in real estate, but also unlucky in the outcome of the litigation.

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