NOTE: EMPLOYMENT COURT ORDER PROHIBITING PUBLICATION OF NAME AND IDENTIFYING PARTICULARS OF APPELLANT REMAINS IN FORCE

IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA4/2019
[2020] NZCA 12

BETWEEN	TUV Appellant
AND	CHIEF OF NEW ZEALAND DEFENCE FORCE Respondent

Hearing: 31 October 2019

Court: French, Courtney and Goddard JJ

Counsel: A J Douglass and M J Taylor-Cyphers for Appellant
J G Drayton and J P A Boyle for Respondent

Judgment: 11 February 2020 at 2.00 pm

JUDGMENT OF THE COURT

A The appeal is dismissed.

B We answer the questions of law submitted for determination by the court:

(a) Does s 149(3) of the Employment Relations Act 2000 operate as a statutory bar to the setting aside of certified s 149 agreements? No.

(b) Does the test in the Privy Council decision of *O'Connor v Hart*, subsequently applied in other courts of New Zealand, apply in the employment jurisdiction (and to certified s 149 agreements) being that a contract cannot be voidable for mental incapacity unless

the other contracting party has knowledge (actual or constructive) of the incapacity, or equitable fraud is established?

Yes.

C There is no order as to costs.

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REASONS OF THE COURT

(Given by Goddard J)

Introduction and summary

[1] Many employment disputes are settled. The employee and the employer enter into a settlement agreement which resolves the differences between them. This appeal concerns the enforceability of a settlement agreement entered into by an employee who lacked capacity to enter into that agreement as a result of mental illness. The employee wants to bring proceedings before the Employment Relations Authority

(ERA). The employer, the Chief of the New Zealand Defence Force, says the claim has been settled and cannot be reopened.

[2] The first issue raised by the appeal is whether s 149 of the Employment Relations Act 2000 (Act) prevents the employee from challenging the settlement agreement on the basis that she lacked capacity to enter into it. Where an employment dispute is resolved, the parties may ask a mediator employed or engaged by the Ministry of Business, Innovation and Employment (MBIE) to sign the agreed terms of settlement under s 149. Section 149 sets out certain procedural steps that must be taken by the mediator. It goes on to provide that where the agreed terms of settlement are signed by a mediator, those terms are final and binding on, and enforceable by, the parties. The terms may not be cancelled under ss 36 to 40 of the Contract and Commercial Law Act 2017.[1] Except for enforcement purposes, no party may seek to bring those terms before the Employment Authority or the Court, whether by action, appeal, application for review, or otherwise.[2]

[3] The Employment Court held, and we agree, that s 149 does not prevent a challenge to a settlement agreement on the grounds of incapacity.[3] If a settlement agreement is set aside because the employee lacked capacity to enter into it, there are no agreed terms of settlement to which s 149 could apply.

[4] The second issue raised by the appeal is whether the test for setting aside a settlement agreement in relation to an employment dispute on the grounds of incapacity is different from the test that applies to contracts generally. Under the general law of contract, a contract is voidable if:[4]

(a) one party lacked capacity to enter into that contract as a result of mental illness; and

(b) the other party knew of that incapacity, or ought to have known of it.

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1 Employment Relations Act 2000, s 149(3)(ab).
2 Section 149(3)(b).
3 *TUV v WXY* [2018] NZEmpC 154 (Employment Court judgment).
4 *O'Connor v Hart* [1985] 1 NZLR 159 (PC); *GE Custodians v Bartle* [2010] NZSC 146, [2011] 2 NZLR 31; *Westpac New Zealand Ltd v Map & Assocs Ltd* [2011] NZSC 89, [2011] 3 NZLR 751; and *Gustav & Co Ltd v Macfield Ltd* [2008] NZSC 47, [2008] 2 NZLR 735.

[5] We do not consider that a different test should apply to agreements settling employment disputes. In this case, the Employment Court held that the employer did not know of the employee's incapacity and had no reason to suspect it.[5] The Employment Court was right to find that in these circumstances, the settlement agreement was not voidable. It is binding on both parties. The dispute has been settled, and cannot be reopened before the ERA.

[6] We set out our reasons for these conclusions below.

Background

[7] The relevant facts can be stated very briefly.

[8] The employee was employed by the employer for many years. Issues arose which led to an employment dispute. The employee sought medical attention, and was absent from work on stress leave for an extended period.

[9] Discussions and correspondence took place between a lawyer acting for the employee and the employer's director of human resources, with a view to resolving the parties' differences. These exchanges resulted in the preparation of a written settlement agreement which was signed by the parties on 1 December 2015. A mediator employed by the Chief Executive of MBIE was contacted, and asked to sign the agreement under s 149 of the Act. The mediator spoke to the plaintiff over the telephone. The mediator signed the agreement on 15 December 2015.

[10] The employee subsequently filed a claim in the ERA alleging that she had been unjustifiably constructively dismissed. Her claim alleged discrimination and workplace bullying. The employer argued that the claim was precluded by the settlement agreement. The Authority dealt with this as a preliminary issue.

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5 Employment Court judgment, above n 3, at [69].

ERA determination

[11] The ERA declined to set aside the settlement agreement.[6] The ERA found that the employee did not lack the capacity to enter into the agreement.[7] The ERA also found that there was no material indication to the employer which would have reasonably led it to conclude that the employee lacked capacity to enter into the settlement agreement.[8]

[12] The ERA also held that the bargain reflected in the settlement agreement was not unconscionable, and that the employee did not enter into the settlement agreement as a result of duress.[9]

Employment Court judgment

[13] The employee appealed to the Employment Court, which reheard the preliminary issue de novo.

Effect of s 149

[14] Chief Judge Inglis found that s 149 does not prevent the Court from inquiring into a settlement agreement on the grounds of mental incapacity.[10] The Chief Judge considered that s 149 is directed at limiting the circumstances in which parties can revisit their agreements by seeking to bring the terms of settlement before the Court.[11] It is not directed at deeming validity of the agreement itself.[12]

[15] The Chief Judge set out her conclusions on this issue as follows:

> [46] … if the plaintiff can establish that she did not have the requisite mental capacity to enter into the settlement agreement in this case, then s 149(3) would not be engaged. That is because the fundamentals of contractual formation would not have been made out and there would be no agreement for s 149(3) to leverage off. Such cases are likely to be rare because of the hurdles that must be overcome in establishing, for example, lack of mental capacity, knowledge and unconscionability.

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6 *TUV v WXY* [2017] NZERA Christchurch 222 (ERA determination).
7 At [69].
8 At [70].
9 At [73]–[74] and [80].
10 Employment Court judgment, above n 3, at [46].
11 At [45].
12 At [45].

(Footnote omitted.)

Capacity to enter into settlement agreement

[16] The Chief Judge found that the employee was more likely than not mentally incapacitated when she signed the settlement agreement and when she subsequently spoke to the mediator over the telephone. She also accepted that it was more likely than not that the employee lacked capacity to instruct her lawyer.[13]

[17] The Chief Judge went on to consider whether the employer had knowledge of the employee's mental incapacity at the relevant time. The Chief Judge was not satisfied that the employer knew or ought reasonably to have known that the employee lacked the mental capacity to enter into the settlement agreement.[14]

[18] The Chief Judge noted that the decision of the Privy Council in *O'Connor v Hart* establishes that a contract is voidable for lack of capacity only if one party lacks capacity to enter into it, and the other party knows or ought to have known of that mental incapacity.[15] In this case, the employee was mentally incapacitated, but the employer did not know, and could not reasonably have known, about her lack of capacity.[16]

[19] The Chief Judge expressed some hesitation about whether, in the context of employment settlement agreements, the "second limb" of the *O'Connor v Hart* approach — the requirement that the other party knew or should have known of the incapacity — should apply. She said:

> [65] I have considered whether the second limb of the *O'Connor* approach is a necessary step in this Court's inquiry, and is fatal to the plaintiff's claim. The two-limb approach, requiring a plaintiff to establish mental incapacity and provide evidence that the defendant had knowledge (actual or imputed), appears to have developed in the commercial context, emphasising the desirability of contractual certainty. While contractual certainty is desirable, in the employment sphere it might be said to apply with less force, including having regard to the underlying objectives of the Act. I see a potential danger, given the special nature of employment relationships and the unequal bargaining power implicit in them (as expressly acknowledged in

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13 At [54].
14 At [64].
15 At [55], referring to *O'Connor v Hart*, above n 4, at 167.
16 At [69].

s 3 of the Act), in simply assuming that employment settlement agreements reached via mediation ought to be treated in precisely the same way as other (including purely commercial) contracts. Indeed, the fact that Parliament legislated to preclude cancellation in certain circumstances may be said to reinforce the fact that s 149 settlement agreements stand apart from regular contractual arrangements. And, as has been confirmed in many Court of Appeal cases, employment law is a specialist jurisdiction which is focussed on resolving problems between parties to an employment relationship, rather than on strict contractual principles.

[66] Under s 189 the Court has, for the purpose of supporting successful employment relationships and promoting good faith behaviour, jurisdiction to determine all matters in such manner and to make such decisions and orders, not inconsistent with the Act or any other Act, as "in equity and good conscience it thinks fit." It might be argued that setting aside an agreement entered into with a party lacking the requisite capacity, whether or not the employer knew or ought to have known of it, would lead to a result *consistent* with equity and good conscience, even weighing the countervailing policy consideration of certainty of contract. The point might be even more strongly made where the mental incapacity was actually caused or triggered by the employer's unjustified actions or inactions during the course of the employment relationship. To put it another way, it may be relevant that one party (in breach of their employment obligations, including to act in good faith) has driven the other party to the point of mental incapacity.

[67] The outcome in this case, of limiting the inquiry to limb one, would be that the defendant, a large government sector organisation, would face the prospect of an employment claim that it acted unlawfully in the way in which it dealt with performance issues involving the plaintiff that it thought it would not have to confront. There is no other evident prejudice involved, other than that generally associated with the passage of time. The flip side is that a person assessed as lacking sufficient mental capacity at the time they signed away their legal rights to access the employment institutions, would be able to pursue those rights in circumstances where no other right of challenge, appeal or judicial review is available.

[68] The Court of Appeal has not yet had the opportunity to consider the extent to which s 149 acts as an impenetrable shield to the pursuit of claims and (if not) whether the generally applied approach to mental incapacity applies to employment settlement agreements. However, given the clear approach currently adopted by the courts, including the Court of Appeal, to the second limb test for mental incapacity, I feel constrained to approach this case in the same way.

(Footnotes omitted.)

[20] Applying the orthodox approach, the settlement agreement was not liable to be set aside because the employer did not know, and could not reasonably have known, of the employee's incapacity.[17]

Unconscionability and duress

[21] The Chief Judge found that the agreement was not unconscionable. She said:

> [73] … The reality is that the plaintiff was represented by an experienced employment lawyer who negotiated an unremarkable settlement agreement based on conventional terms that were reasonably evenly weighted. The agreement was fair and reasonable, and falls well short of representing an unconscionable bargain.
>
> (Footnote omitted.)

[22] The Chief Judge also found that the employee had not signed the agreement under duress.[18]

Leave to appeal to this Court

[23] The employee sought leave to appeal to this Court. The employer accepted that the appeal raised issues of general and public importance and consented to the application for leave to appeal. The Court granted leave to appeal on the following questions:[19]

> a. Does s 149(3) of the Employment Relations Act 2000 operate as a statutory bar to the setting aside of certified s 149 agreements?
>
> b. If the answer to a. is no, does the test in the Privy Council decision of *O'Connor v Hart*, subsequently applied in other courts of New Zealand, apply in the employment jurisdiction (and to certified s 149 agreements) being that a contract cannot be voidable for mental incapacity unless the other contracting party has knowledge (actual or constructive) of the incapacity, or equitable fraud is established?

[24] We address each of those issues in turn below.

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17 At [69].
18 At [80].
19 *TUV v WXY* CA4/2019, 8 February 2019.

First issue: Does s 149 preclude setting aside the settlement agreement?

The issue

[25] Section 149 provides:

> **149 Settlements**
>
> (1) Where a problem is resolved, whether through the provision of mediation services or otherwise, any person—
>
> (a) who is employed or engaged by the chief executive to provide the services; and
>
> (b) who holds a general authority, given by the chief executive, to sign, for the purposes of this section, agreed terms of settlement,—
>
> may, at the request of the parties to the problem, and under that general authority, sign the agreed terms of settlement.
>
> (2) Any person who receives a request under subsection (1) must, before signing the agreed terms of settlement,—
>
> (a) explain to the parties the effect of subsection (3); and
>
> (b) be satisfied that, knowing the effect of that subsection, the parties affirm their request.
>
> (3) Where, following the affirmation referred to in subsection (2) of a request made under subsection (1), the agreed terms of settlement to which the request relates are signed by the person empowered to do so,—
>
> (a) those terms are final and binding on, and enforceable by, the parties; and
>
> (ab) the terms may not be cancelled under sections 36 to 40 of the Contract and Commercial Law Act 2017; and
>
> (b) except for enforcement purposes, no party may seek to bring those terms before the Authority or the court, whether by action, appeal, application for review, or otherwise.
>
> (3A) For the purposes of subsection (3), a minor aged 16 years or over may be a party to agreed terms of settlement, and be bound by that settlement, as if the minor were a person of full age and capacity.
>
> (4) A person who breaches an agreed term of settlement to which subsection (3) applies is liable to a penalty imposed by the Authority.

[26] The first question before us is whether a settlement agreement that has been signed by a mediator under s 149 can be challenged before the Courts on the grounds that a party lacked mental capacity to enter into that agreement.

Employer's submissions in relation to s 149

[27] The employer says that the meaning of the words in s 149(3)(b) is plain: "except for enforcement purposes, no party may seek to bring those terms before the Authority or the Court, whether by action, appeal, application for review, or otherwise".

[28] The employer also notes that under s 152(2)(a) a s 149 settlement agreement can be challenged or called into question on the grounds that the mediator failed to comply with the procedural requirements in sub-sections (2) and (3) of s 149. The employer says that settlement agreements can be challenged on these procedural grounds, but not otherwise.

[29] The employer put some emphasis on the legislative history of s 149. Section 88(2) of the Employment Contracts Act 1991 provided for settlement agreements to be signed by a mediator only where the settlement resulted from the provision of mediation services. It read:

> (2) Where a member of the Tribunal provides mediation services within the adjudication jurisdiction of the Tribunal, and as a result the parties conclude a settlement or agree to the member making a decision, the parties may request the member to sign the terms of settlement and in any such case those terms of settlement shall be final and binding on the parties.

[30] The expansion of the role of mediators to include signing settlement agreements that had not been reached as a result of mediation services provided under the Act was consistent with the Act's focus on:[20]

> … the prior resolution of problems by the parties themselves, who will have access to a wide range of resources, through information provision, structured or unstructured mediation and other services to voluntarily resolve matters at an early stage.

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[20] Employment Relations Bill 2000 (8-1) at 8.

[31] The employer also emphasised that at the Committee of the Whole House stage of the Employment Relations Bill, an amendment to the Bill was proposed by the Opposition. The amendment would have inserted an additional subsection providing for settlements to be challenged on the grounds that they are unconscionable. The Government voted against the proposed amendment. The employer submitted that the rejection by Parliament of the proposed amendment showed a clear Parliamentary intention that there would be a statutory bar to the setting aside of s 149 settlement agreements on the grounds of unconscionability, or other equitable doctrines.

[32] The employer also drew our attention to a 2004 amendment to the Act. In *Hunt v Forklift Specialists Ltd*, a case decided under the Employment Contracts Act 1991, the Employment Court found that settlement agreements entered into pursuant to s 88 of that Act could be cancelled by the innocent party under the Contractual Remedies Act 1979 if the other party failed to comply with the agreement.[21] After the Act was enacted in 2000, several decisions of the ERA adopted the same approach in relation to s 149 settlement agreements.[22] Section 149 was amended by the Employment Relations Amendment Act (No 2) 2004 by inserting s 149(3)(ab), which provided that the terms of an agreed settlement "may not be cancelled under section 7 of the Contractual Remedies Act 1979".[23] The employer submits that the insertion of para (ab) was a response to the ERA decisions following *Hunt*, and reflected a policy of preventing challenges to s 149 agreements.

[33] The employer says that this statutory history confirms that s 149(3)(b) should be read as preventing challenges to settlement agreements that have been signed by a mediator under s 149 on any grounds, except perhaps actual fraud.

[34] The employer submits that there are strong policy reasons supporting this approach, in particular certainty for parties entering into s 149 agreements. If s 149 agreements can be set aside on grounds of mental incapacity, or other grounds, that

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21 *Hunt v Forklift Specialists Ltd* [2000] 1 ERNZ 553 (NZEmpC).

22 *CN v H* ERA Christchurch CEA 102/03, 28 November 2003; and *House v Samuel Miller Films Ltd* ERA Christchurch CEA 189/02, 17 July 2002.

23 Employment Relations Amendment Act (No 2) 2004, s 51(1). That Act also added s 149(4), which provides for a party who breaches an agreed term of settlement to be liable to a penalty.

would undermine public confidence in s 149 settlements. It would mean that the "floodgates would be wide open" and settlement agreements would be set aside in many cases.

[35] The employer says that the UK decisions finding that the UK Employment Tribunal has jurisdiction to set aside a settlement agreement on the grounds of misrepresentation or lack of capacity, which were referred to in the Employment Court judgment, provide no assistance in New Zealand.[24] There are significant differences in the statutory frameworks.

[36] The employer drew our attention to *Bagley v Deloitte Ltd* in which the ERA, in reliance on the Employment Court judgment in this case, found that a settlement agreement entered into under s 149 was not valid on the grounds of misrepresentation.[25] The employer submitted that that decision was clearly wrong, having regard to the specific exclusion of cancellation for misrepresentation in s 149(3)(ab); but it illustrated the level of uncertainty and confusion generated by the Employment Court judgment.

Discussion

[37] The meaning of s 149 must be ascertained from its text in light of its purpose.[26] Even if the meaning of the text appears plain in isolation from purpose, that meaning must always be cross-checked against purpose. In determining purpose the Court must have regard to both the immediate and general legislative context. The social, commercial or other objectives of the enactment may also be relevant.[27]

[38] We consider that the conclusion reached by the Chief Judge is consistent with both the text and the purpose of s 149.

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[24] *Glasgow City Council v Dahhan* UKEAT Edinburgh UKEATS/0024/15/JW, 11 May 2019; and *Industrious Ltd v Horizon Recruitment Ltd (in liq)* [2009] UKEAT London UKEAT/0478/09, 11 December 2009.

[25] *Bagley v Deloitte Ltd* [2019] NZERA 427.

[26] Interpretation Act 1999, s 5(1).

[27] *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767 at [22].

[39] Section 149 refers to the "agreed terms of settlement". It is those agreed terms of settlement that cannot be challenged before a Court. But the existence of agreed terms of settlement depends on there being a valid contract between the parties in which those terms are incorporated. If a settlement agreement is voidable because a party lacked capacity, and is set aside, there is no contract and the parties are restored to their pre-contract position. So there are no "agreed terms of settlement".

[40] Further textual support for this approach is found in s 149(3A), which provides that a minor aged 16 years or over may be a party to agreed terms of settlement and be bound by that settlement as if the minor were a person of full age and capacity. If s 149 precluded challenges to an agreement based on lack of capacity, subsection (3A) would not be necessary: a minor aged 16 years or over would not have been able to raise issues of capacity in any event. And it is implicit in this provision that so far as minors aged under 16 are concerned, the general law applies and they are able to challenge a settlement agreement on the grounds that they lacked capacity. There would be no point in drawing a line at the age of 16 in subsection (3A) if the position was the same for minors above or below that age as a result of s 149(3).

[41] Similar inferences can be drawn from s 149(3)(ab) in relation to cancellation under ss 36–40 of the Contract and Commercial Law Act (formerly s 7 of the Contractual Remedies Act). This provision, which as noted above was inserted in the Act in 2004, precludes cancellation on the basis of misrepresentation, serious breach, or repudiation. This provision would not be necessary if s 149(3)(a) and (b) precluded a challenge to agreed terms of settlement on any basis whatsoever. The express exclusion of the ability to cancel a settlement agreement under specified provisions of the Contract and Commercial Law Act also strongly suggests that the ability to challenge agreed terms of settlement under other provisions of that Act — for example, s 24 in relation to relief for mistake, or s 73 in relation to illegal contracts — is not affected by the general language in s 149(3)(a) and (b).

[42] That is not a surprising conclusion. The purpose of s 149 is to prevent the reopening of a valid settlement agreement. But Parliament did not in our view intend the limited procedural safeguards in s 149 to override the important protections for individuals and for the public interest reflected in the law relating to validity of

contracts. Facilitating settlement of employment disputes is an important objective. So too is certainty. But these objectives do not trump the policy objectives and basic legal values reflected in the law relating to capacity, and in the law concerning other grounds for finding that a contract is void or is liable to be set aside.

[43] Consider, for example, a settlement agreement between an employer and an employee with significantly impaired mental capacity. The employer knows of the employee's incapacity, and deliberately exploits it to secure an agreement that is very disadvantageous to the employee. We cannot identify any sensible policy rationale for enforcing such an agreement against the employee. Doing so could not be reconciled with fundamental principles of the common law. Nor could it be reconciled with the values of good faith and redress of power imbalances that underpin the Act itself.[28]

[44] The same reasoning applies in relation to other grounds on which an agreement is liable to be set aside, such as duress, undue influence or unconscionability. It would be abhorrent for a settlement agreement that an employer had procured by duress to be enforced merely because it had been signed by a mediator under s 149. Yet that would be the consequence of the employer's argument in this case.

[45] We are confident that Parliament did not intend s 149 to override the law relating to capacity, duress, unconscionability or other grounds for finding that a contract is void or voidable at its inception. The purpose of s 149 does not require such a far-reaching and surprising result. The broader purposes of the Act reflected in ss 3 and 4 point very much the other way.

[46] Different policy considerations arise in relation to cancellation of an agreement for serious breach or repudiation, where no issue arises about the validity of the agreement at the time it was entered into. In circumstances where one party has failed to perform the agreement, or has made it clear that they do not intend to perform their obligations, there is no unfairness in holding the parties to their (valid) agreement: the parties' interests can be fully protected by enforcing the agreement or awarding damages for breach. Section 149(3)(ab) appears to be intended to ensure

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[28] See in particular Employment Relations Act, ss 3 and 4.

that in these circumstances settlements remain effective, and the original employment dispute is not reopened — it was validly settled, and should remain settled. There is a clear and principled distinction between this scenario and the scenarios discussed above where a contract is void or voidable at its inception.

[47] We note in passing that s 149(3)(ab) may have the surprising, and presumably unintended, consequence of preventing cancellation of a settlement agreement that was procured by fraud. We cannot see any policy justification for holding either party — employer or employee — to a settlement agreement that was procured by a fraudulent misrepresentation made by the other party. Yet that appears to be the consequence of s 149(3)(ab) precluding cancellation under s 37(1)(a) of the Contract and Commercial Law Act. Similar, though less acute, concerns arise in relation to a settlement agreement that is procured by a misrepresentation that is not fraudulent. This is an issue that Parliament may wish to consider in the context of any future review of the Act.

[48] The first question in relation to which leave to appeal was granted is:

> Does s 149(3) of the Employment Relations Act 2000 operate as a statutory bar to the setting aside of certified s 149 agreements?

[49] The answer is no.

Second issue: Approach to incapacity in the employment context

The issue

[50] As the Privy Council confirmed in *O'Connor v Hart*, a contract is voidable at the option of a party to that contract if at the time of entry into the contract:[29]

> (a) that party lacked the mental capacity to enter into the transaction; and
>
> (b) the other party knew or ought to have known of that lack of capacity.

[29] *O'Connor v Hart*, above n 4, at 174.

[51] The second question in respect of which leave to appeal to this Court was granted is whether, in circumstances where an employee lacks capacity to enter into a settlement agreement, that agreement is voidable only if the employer knows or ought to know of their incapacity. In other words, does the second limb of the test set out above apply to settlements of employment disputes? Or is there a different rule in this context?

Employee's submissions on appeal in relation to effect of incapacity

[52] The employee submitted that in the employment context, a settlement agreement entered into by an employee who lacked the necessary capacity to do so is void, or in the alternative voidable, whether or not the employer knows of that incapacity. The employee emphasised the inherent inequality of power in employment relationships, recognised in s 3(a)(ii) of the Act, and the requirement in s 4 that the parties to an employment relationship must deal with each other in good faith. She argued that it would be unfair and oppressive to hold an employee who lacked capacity to an agreement that they had entered into in circumstances where they could not properly appreciate its implications. Because the employee lacked capacity to enter into the settlement agreement, there was no *consensus ad idem* or meeting of the minds. So there was no genuine agreement.

[53] The employee argued that the common law test as it applies to commercial contracts ought not to apply in the employment jurisdiction. In the commercial context, she submitted, a premium is placed on certainty. In the employment context, greater emphasis should be given to protection of the vulnerable party from disadvantage. The Employment Court is a court of equity and good conscience.[30] It would be contrary to equity and good conscience to enforce a settlement agreement against an employee who was not capable of understanding its implications, and making a free and informed decision to settle the dispute.[31]

[54] In the alternative, the employee submitted that the employer should be treated as having knowledge of the employee's incapacity where the employer caused or

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30 Employment Relations Act, ss 157, 160 and 189.
31 See Employment Court judgment, above n 3, at [65]–[66].

contributed to the employee's mental health condition: an approach foreshadowed by the Chief Judge.[32] In those circumstances, it was submitted, the employer has a positive duty to make inquiries. They should be treated as knowing all matters which would have been disclosed by such inquiries.

[55] Yet another option advanced on behalf of the employee in the course of oral argument was that in the employment context, a contract should be voidable if the employee lacks capacity and the contract is substantively unfair.

[56] The employee also argued that unconscionability and duress are independent grounds for the Court to intervene, even where no issue of capacity arises. In this case, the employer's passive acceptance of the settlement agreement was unconscionable. And the employee was acting under duress.

Discussion

The balance struck by the orthodox approach to capacity

[57] The law of contract seeks to strike a balance between respect for the autonomy of contracting parties and protection of the vulnerable, including those who are vulnerable as a result of mental illness.

[58] If a party lacks capacity, and the other party knows this, there can be no justification for enforcing a contract between them if the incapacitated party (or their representative) wishes to set it aside. Similarly, if the other party is on notice that an individual may lack capacity, they should not be permitted to turn a blind eye to those circumstances and take the benefit of a contract that exploits that incapacity. Rather, if they refrain from making inquiries, they take the risk that the contract will be set aside because the other party lacked capacity to enter into it.

[59] But on the orthodox approach, a contracting party dealing with an individual who is not a minor can proceed on the basis that that individual has contractual capacity unless they know the individual lacks capacity, or are aware of circumstances that would put a reasonable person on inquiry about the individual's capacity. They

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[32] At [66].

can enter into contracts with that individual without needing to actively inquire into questions of capacity, absent such notice, and do not face the risk of subsequent invalidation of the contract on the basis of a lack of capacity. That approach is consistent with the objective approach to contract formation that underpins the common law of contract. It promotes certainty. It also reduces barriers to contracting for individuals, because other people who deal with them can assume capacity and do not need to make inquiries or take other active steps to ascertain their capacity.

[60] If capacity could not be assumed, then in some (potentially quite broad) circumstances the risk of a contract being voidable for incapacity would incentivise businesses and other people entering into significant transactions with individuals to seek comfort on that issue: for example, by requiring a certificate in relation to capacity from the individual's lawyer or a doctor. That would increase the cost and practical difficulty of contracting for many individuals — not just those who do in fact lack capacity. The cost and inconvenience of steps of this kind could prevent entry into contracts that those individuals wish to enter into and would benefit from. In other cases, the contract would be entered into despite the cost and inconvenience of such steps, but that additional cost would be borne by the parties — including the individuals who were required to take steps to establish their capacity to enter into the contract. The purpose of the second limb of the test in *O'Connor v Hart* is to avoid creating barriers to contracting and costs of contracting of this kind.

[61] Nor, it should be noted, is this a test that has been developed solely — or even primarily — in a commercial context. *O'Connor v Hart* itself was a case about an elderly farmer selling a family farm. All cases about mental capacity by definition concern dealings by individuals. Many of these are family transactions rather than truly commercial transactions.

No sufficient reason to depart from the orthodox approach

[62] The employee argued that there is real unfairness to an employee in being held to a contract they did not have the capacity to understand and enter into, regardless of the employer's knowledge. We recognise the force of that argument. But that is true

in other contexts — it is not a factor peculiar to the employment context, and does not suggest that the balance struck by the established test is any less applicable in the employment context.

[63] The "equity and good conscience" character of the employment jurisdiction does not require a different approach. Equitable doctrines such as duress, undue influence and unconscionability all depend on the stronger party having knowledge of, and exploiting, the vulnerability or disadvantage of the other party. That is not surprising. The stronger party's conscience is not affected if they neither know, nor have reason to know, of the vulnerability or disadvantage affecting the other party. It is not contrary to good conscience to enter into an agreement in the absence of knowledge of some factor that makes it unconscionable to do so.

[64] It might be argued that it is contrary to equity and good conscience for the stronger party to hold the weaker party to an agreement if they subsequently become aware of the vulnerability or disadvantage of the other party. But that is not the approach taken by the courts of equity in any of these contexts, and we do not consider that the employment context is so different that it requires a different result.

[65] Indeed the wider statutory context points very much the other way. Section 68 of the Act sets out the circumstances in which an individual employment agreement can be set aside as unfair as a result of disability, undue influence, duress, or certain other factors. It provides:

> **68 Unfair bargaining for individual employment agreements**
>
> (1) Bargaining for an individual employment agreement is unfair if—
>
> (a) 1 or more of paragraphs (a) to (d) of subsection (2) apply to a party to the agreement (**person A**); and
>
> (b) the other party to the agreement (**person B**) or another person who is acting on person B's behalf—
>
> (i) knows of the circumstances described in the paragraph or paragraphs that apply to person A; or
>
> (ii) ought to know of the circumstances in the paragraph or paragraphs that apply to person A because person B or the other person is aware of facts or other circumstances from which it can be reasonably

inferred that the paragraph or paragraphs apply to person A.

(2) The circumstances are that person A, at the time of bargaining for or entering into the agreement,—

(a) is unable to understand adequately the provisions or implications of the agreement by reason of diminished capacity due (for example) to—

(i) age; or

(ii) sickness; or

(iii) mental or educational disability; or

(iv) a disability relating to communication; or

(v) emotional distress; or

(b) reasonably relies on the skill, care, or advice of person B or a person acting on person B's behalf; or

(c) is induced to enter into the agreement by oppressive means, undue influence, or duress; or

(d) where section 63A applied, did not have the information or the opportunity to seek advice as required by that section.

(3) In this section, **individual employment agreement** includes a term or condition of an individual employment agreement.

(4) Except as provided in this section, a party to an individual employment agreement must not challenge or question the agreement on the ground that it is unfair or unconscionable.

[66] Parliament has codified the rules relating to mental incapacity and unconscionability in the context of bargaining for individual employment agreements. The code set out in s 68 requires both that there be circumstances affecting the ability of the employee to understand the agreement or make a free and autonomous decision to enter into the agreement,[33] and that the other party knows or ought to know of the relevant circumstances.[34] Section 68 confirms that a knowledge requirement akin to the second limb of the *O'Connor v Hart* test is consistent with the purpose of the Act and the values that underpin it.

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33 Employment Relations Act, ss 68(1)(a) and (2).

34 Section 68(1)(b).

The United Kingdom caselaw is not relevant

[67] Counsel for the employee referred us to the decision of the United Kingdom Supreme Court in *Dunhill v Burgin*.[35] The Court affirmed the general principle that capacity is issue-specific and that capacity is to be judged in relation to the decision or activity in question and not globally.[36] The Court held that Ms Dunhill lacked the capacity to commence and conduct proceedings arising out of a personal injury claim against Mr Burgin.[37] Ms Dunhill ought to have had a litigation friend from the outset. Any settlement she entered into required approval by the Court under the Civil Procedure Rules 1998 (UK).[38] Because she did not have a litigation friend and the settlement she had entered into had not been approved by the Court, the settlement was of no effect.[39]

[68] As the Court noted in *Dunhill*, the regime for approval of settlement agreements under the Civil Procedure Rules is a significant exception to the general position under English law that a contract entered into by a person who lacks capacity is voidable only if that lack of capacity is known, or ought to be known, to the other party.[40] The law in New Zealand in relation to settlement agreements is different in two important respects. First, there is no general requirement that a settlement entered into by a person who lacks capacity must be approved by the Court. Second, under the High Court Rules 2016 a step in a proceeding taken by an incapacitated person who does not have a litigation guardian is not void. Rather, r 4.34 provides:

> **4.34 Court may set aside a step in a proceeding**
>
> The court may set aside a step in a proceeding if an incapacitated person did not have a litigation guardian when that step was taken and the Court considers that the incapacitated person was unfairly prejudiced.

[69] Rule 4.34 was not engaged in this case, as a settlement agreement was entered into before any proceedings had been commenced in any court. But if it had applied, it would not have led to a different result in this case. As noted above,

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35 *Dunhill v Burgin* [2014] UKSC 18, [2014] 1 WLR 933.
36 At [13].
37 At [34].
38 At [34].
39 At [21] to [33].
40 At [30].

the Employment Court found that the settlement agreement was unremarkable and was not unfair to the employee. There was no unfair prejudice of the kind that would result in a step being set aside under r 4.34.

The employee's alternative arguments

[70] The employee advanced a number of alternative arguments, in the event that her primary argument that the second limb of the *O'Connor v Hart* test should not apply was unsuccessful.

[71] Her first alternative argument was that the employer can be treated as having knowledge of a lack of capacity where that lack of capacity was caused or contributed to by the conduct of the employer. This does not follow as a matter of logic. It is perfectly possible for the conduct of an employer to have caused mental health problems for an employee, but for the employer not to be aware of those mental health problems.

[72] This alternative argument may be better understood as an argument that knowledge on the part of the employer is not required — the second limb of the *O'Connor v Hart* test does not apply — where the employer has caused or contributed to the employee's mental illness and resulting lack of capacity. That is how the argument was framed by the Chief Judge in her discussion of alternative approaches to this issue.[41]

[73] We doubt that an argument along these lines is within the scope of the leave granted by this Court. But in any event, we consider that there is no reason to modify the orthodox approach to issues of capacity in the manner contended for, for the reasons set out above.

[74] If the employer has breached their obligations to the employee in a manner that has caused or contributed to a mental illness affecting capacity, then they will be liable for the harm they have caused. If the employee pursues a claim for that harm against the employer, and alleges that they suffer from a mental illness as a result of

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41 Employment Court judgment, above n 3, at [66].

the employer's breaches, then the employer will be on notice that there may be an issue of capacity; if they proceed to settle with the employee in the absence of a litigation guardian, then the agreement will be voidable at the option of the employee. No special rule is required to achieve this result.

[75] But if the employee makes a claim without alleging a mental illness or any other matters that put the employer on notice of a possible lack of capacity, and there is nothing else to put the employer on notice, then there are good reasons not to require the employer to bear the risk of possible incapacity. An approach that did not require knowledge or notice of incapacity where the incapacity was contributed to by the employer's conduct would hinder entry into settlement agreements, especially in the common scenario where an employee claims to have suffered stress as a result of the employer's actions. It would be likely to result in employers seeking confirmation of an employee's capacity to settle a dispute in many cases where the employee does have capacity. The additional cost and inconvenience involved would disadvantage a significant number of employees and employers. We do not consider that it is justified in the employment context, any more than in other contractual contexts.

[76] The second alternative argument advanced on behalf of the employee was that in the employment context, a contract should be voidable if the employee lacks capacity and there is substantive unfairness. This argument faces a number of difficulties. The first (insuperable) difficulty is that the Employment Court found that there was no substantive unfairness in this case: the agreement was unremarkable. The second difficulty is that for the reasons set out above we consider that the general rule concerning capacity applies in the employment context: a contract is voidable because an employee lacks capacity only where the employer knows or ought to have known of that lack of capacity.

[77] The employee's final alternative argument, contending that the settlement agreement should be set aside on the grounds of unconscionability or duress, did not come within the terms of the leave granted by this Court. But in any event that argument could not succeed on the facts. Nothing amounting to duress was made out in this case. And as explained above, a bargain is unconscionable only if the stronger party knows or ought to know of the disability or disadvantage affecting the weaker

party. Otherwise, their conscience is not affected and the agreement is not voidable in equity. The Employment Court found that the employer neither knew nor ought to have known of the employee's impaired capacity. So there is no factual basis for a challenge on the grounds of unconscionability.

Decision on the second issue

[78] The second question in respect of which leave was granted was:

> If the answer to a. is no, does the test in the Privy Council decision of *O'Connor v Hart*, subsequently applied in other courts of New Zealand, apply in the employment jurisdiction (and to certified s 149 agreements) being that a contract cannot be voidable for mental incapacity unless the other contracting party has knowledge (actual or constructive) of the incapacity, or equitable fraud is established?

[79] The answer is yes.

Conclusion

[80] Our answers to the two questions in respect of which leave to appeal was granted are set out at [48]–[49] and [78]–[79] above. We have upheld the decision of the Employment Court on both issues. The appeal is therefore dismissed.

[81] The employee was successful on the first issue. The employer was successful on the second issue. In those circumstances, we consider that costs should lie where they fall.

[82] The employer submitted that if the appeal was dismissed, it should receive costs. Counsel for the employer submitted that both questions had been proposed by the employee when seeking leave to appeal, and the employer as respondent simply consented to the two issues being raised. However, we consider that in identifying both issues for consideration by this Court, the employee was simply recognising the inevitability that, if the second issue was raised by the employee, the employer would wish to argue the first. If the employer had responded to the application for leave by saying that the s 149 issue was conceded, and they did not wish to pursue it on appeal, it would not have been necessary for this Court to address it. It occupied

at least half of the hearing time before us. We therefore remain of the view that costs should lie where they fall.

Result

[83] The appeal is dismissed.

[84] We answer the questions of law submitted for determination by the Court as follows:

(a) Does s 149(3) of the Employment Relations Act 2000 operate as a statutory bar to the setting aside of certified s 149 agreements?

No.

(b) Does the test in the Privy Council decision of *O'Connor v Hart*, subsequently applied in other courts of New Zealand, apply in the employment jurisdiction (and to certified s 149 agreements) being that a contract cannot be voidable for mental incapacity unless the other contracting party has knowledge (actual or constructive) of the incapacity, or equitable fraud is established?

Yes.

[85] There is no order as to costs.

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