

Can a record of settlement be set aside on the basis of mental incapacity?

Supreme Court confirms the position

Employment problems are commonly resolved by way of a special settlement agreement prepared pursuant to section 149 of the Employment Relations Act 2000 (**Act**). These "records of settlement" require sign off from an agent of the Ministry of Business, Innovation and Employment (currently, a mediator).

Records of settlement are widely considered to be robust insofar as they are (seemingly) full and final and cannot be reopened.

A string of cases culminating in a Supreme Court decision examined the validity of these agreements where a party lacked mental capacity at the time the agreement was signed.

The facts

An employee of the New Zealand Defence Force claimed she was subject to bullying and harassment at work. This resulted in an employment dispute, which was settled by way of a record of settlement. Subsequently, the employee argued that she lacked capacity to sign the agreement, which was supported (retrospectively) by medical evidence.

A psychiatrist deemed that the employee was "likely to have been suffering from a significant depressive episode with ongoing anxiety symptoms at the time of signing the [record of settlement] and ... [the employee's] ability to understand all the relevant information within this document is likely to have been impaired..."

The Courts agreed that the employee did not have capacity at the time she signed the record of settlement.

The law

Common (case) law has established that a lack of mental capacity to enter a contract, is alone not enough to void the contract. Voiding the contract requires the

lack of capacity to be known to the counterparty at the time the agreement was entered into. This "two-limb" approach is already recognised in the commercial law context, but the question for the Courts in this case was the extent to which this approach applies to records of settlement in the employment jurisdiction (with its unique, inherently imbalanced bargaining dynamic recognised both in statute and the common law).

The outcome

In a split decision, the Supreme Court agreed with the "two-limb" approach endorsed by the lower Courts to setting aside records of settlement on the basis of mental incapacity.

In the case at hand, the employee lacked capacity (satisfying the first limb), but this was not known to the employer (failing the second limb). For this reason, the record of settlement was not set aside, and remained in force.

In our view this outcome is sensible and consistent with the object of the Act, which is to promote good faith relations and fast and inexpensive resolution of employment problems.

The alternative outcome would have seen records of settlement being reopened years later where there was no knowledge of incapacity at the time of entering the agreement. As mentioned in the Supreme Court judgment, this would have undercut the utility of these agreements for employers, and resulted in employers requiring that employees undergo intrusive medical examination to ensure their capacity.

Considerations

The decisions usefully examined the point at which an employer has "knowledge" of an employee's incapacity that could result in a record of settlement being set aside.

This includes actual knowledge, such as receiving medical information pertaining to incapacity (such as a

Can a record of settlement be set aside on the basis of mental incapacity (Continued)

medical certificate expressly stating such), and constructive knowledge that may be derived from the employee's behaviour.

For example, significantly increased leave, aggressive or out of character correspondence, volatility, and a decline in job performance may indicate a loss of capacity.

To be clear, the threshold is high. It is expected that resolution of an employment relationship problem will be extremely stressful. However, when there are genuine concerns that an employee may not be able to understand or appreciate a proposed settlement, employers should be cautious of signing the agreement, or risk it later being set aside.

Want to know more?

If you have any questions please contact our specialist [Employment Team](#).